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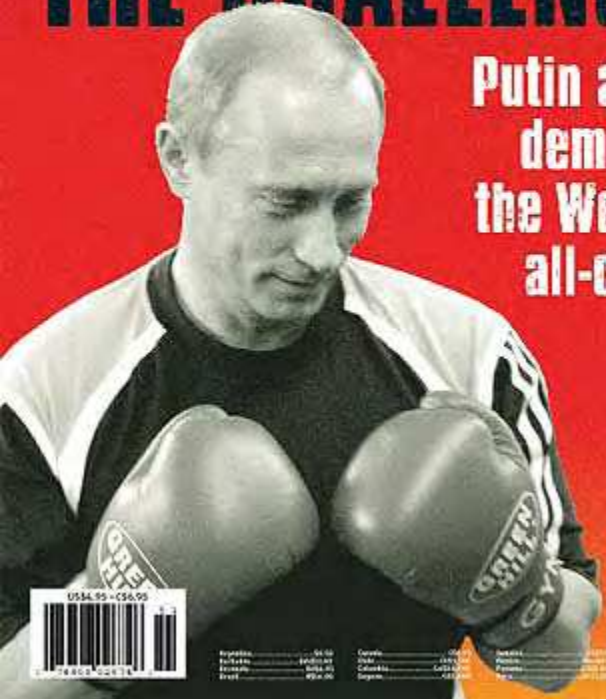
THE CHALLENGER

Putin against democracy, the West and all-comers



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Politics this week

Dec 9th 2004
From The Economist print edition

Do it again

Reuters

Ukraine's parliament adopted a package of measures that pave the way for a re-run of its presidential election on December 26th. The powers of the presidency may be weakened but the opposition candidate, Victor Yushchenko, is expected to win. The American secretary of state, Colin Powell, rejected Russian claims that the West was meddling in Ukraine.

See article

In a show of renewed force, **ETA**, the Basque terrorist group, set off a string of small bombs in Madrid and other cities around Spain. Nobody was seriously hurt, but the bombs have exploded hopes of an early ETA ceasefire.

Hungary's voters said yes to a controversial plan to extend citizenship to some 2.5m ethnic Hungarians living abroad, but not enough voters turned out in the referendum for the change to pass.

Turkey's prime minister, Recep Tayyip Erdogan, objected strongly to suggestions that the European Union should add tough new conditions before agreeing at next week's summit to the opening of Turkish membership talks.

See article

Milan's venerable opera house, **La Scala**, reopened after a three-year overhaul, staging the same obscure opera by Salieri with which it first opened in 1778.

See article

Man of peace, after all

Egypt's president, Hosni Mubarak, said that Ariel Sharon, Israel's prime minister, was the Palestinians' best chance for peace; he condemned a decision by an imprisoned Palestinian leader, Marwan Barghouti, to run for president of the **Palestinian Authority** against Mahmoud Abbas (Abu Mazen), the preferred candidate of Israel and the United States.

Mr Sharon urged **Israel's** ruling Likud party to vote in favour of asking the Labour Party to join his government coalition, to help him implement his plan for Israeli settlers and troops to leave Gaza.

A local cell of **al-Qaeda** claimed responsibility for an attack on the American consulate in Jeddah, Saudi Arabia, in which five expatriates and four out of five terrorists died.

See article

Dozens were reported dead during clashes between militias in **Somalia**. A minister and four deputies quit the country's new transitional government, which meets in Kenya because the Somali capital is too dangerous. The quitters complained that the government was failing to restore order.

Early results of elections in **Mozambique** suggested that Armando Guebuza,

AP

the ruling Frelimo party's presidential candidate, would beat his opposition rival, the Renamo leader Afonso Dhlakama. The winner will replace President Joaquim Chissano, who has ruled since 1986. Observers said the vote seemed fair.

A survey by the International Rescue Committee estimated that 31,000 people continue to die each month because of insecurity in **Congo**, mostly from hunger and disease, although the civil war ended last year.

Boosting intelligence

A bill drastically overhauling America's **intelligence services** finally passed through Congress. The law, which sets up a new spying tsar, lingered in the House until George Bush exerted pressure on conservatives who worried that the bill took too much power away from the Pentagon.

See article

Mr Bush nominated **Bernard Kerik**, a former New York City police commissioner, as his next homeland-security secretary. The White House confirmed that Donald Rumsfeld would stay on as defence secretary. It also scotched rumours that the treasury secretary, John Snow, was about to be ousted.

Louisiana held two congressional run-off elections: the Republicans won one, the Democrats the other. The result of the Washington state governor's race was still in limbo. Democrats asked for a third count of the ballot, in which Dino Rossi, a Republican, holds a tenuous 42-vote lead.

Eliot Spitzer, New York's crusading attorney-general, announced his intention to run for governor in 2006. Mr Spitzer, a Democrat, has courted popularity by using his office to investigate abuses on Wall Street.

See article

Mayhem and the mayor

Mexico's president, Vicente Fox, fired Mexico City's police chief and the commissioner of the Federal Preventive Police over last month's public lynchings of three policemen. The day before, Enrique Salinas, the brother of a former president, had been found murdered on the capital's outskirts; Interpol had recently asked Mexico to help track him down.

See article

Traditional political parties were hammered in mayoral elections in **Bolivia** by candidates from new parties and civic groups.

See article

In the face of political opposition, **Colombia's** government withdrew a bill that would have raised an extra $700m in revenues by increasing value-added tax and taxing pensions. It was a blow for the president, Álvaro Uribe, who just days before had won a constitutional change from Congress allowing him to seek re-election.

Cuba let another political dissident out of jail on top of the six released last week. One umbrella group of dissidents promised a large national meeting for next May.

A court in **Brazil** ordered the government to open files on the dictatorship-era repression of a guerrilla movement in the Araguaia region of the Amazon. The armed forces have recently been forced to acknowledge more of their responsibility for the 1970s dirty war.

South American leaders declared the founding of a continent-wide union, which they hope will one day be like the EU, at a summit in Peru.

See article

Elected president

Hamid Karzai was sworn in as president of **Afghanistan**, making him the first democratically elected leader the country has ever had. He had won an outright majority in elections in October.

See article

India and Pakistan again failed to resolve their differences over a proposed bus service linking the two portions of divided **Kashmir**.

As a message of peace, the **Thai** government dropped around 100m origami birds over the country's Muslim south after a surge of violence there. But a bomb went off shortly afterwards.

AFP

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Business this week

Dec 9th 2004
From The Economist print edition

Champ or chump?

Lenovo, China's leading PC-maker, paid $1.75 billion for IBM's PC business, catapulting the Chinese company into third place in the world's PC market. IBM, inventor of the PC, has steadily moved away from the barely profitable business of making hardware towards the more lucrative areas of services and consulting.

See article

Debt-laden **Telecom Italia** is set to pay *euro*21 billion ($28 billion) for the 44% of **TIM**, a mobile-phone operator, that it does not already own. The deal will allow Telecom Italia to use TIM's healthy cashflow to service its debts and improve its credit rating, although it will have to borrow to finance the deal, temporarily increasing its debt burden.

Meanwhile, **Sprint** announced a $3 billion investment in its mobile-phone networks. America's third-largest mobile operator will use the cash to upgrade networks before the introduction of third-generation services.

All gold

Canada's **Iamgold** suffered a reversal for its audacious attempt to take over **Gold Fields** after the South African firm's shareholders rejected the $2.9 billion deal. The rebuff may open the way for a hostile bid from **Harmony Gold Mining**, a domestic rival, that would create the world's biggest gold-mining company.

Gazprom, Russia's part-state-owned gas monopoly, said that it would bid for Yuganskneftegaz, the main production arm of Yukos, when it is auctioned on December 19th. Bailiffs have put the embattled oil giant's unit up for sale to help with the settlement of tax bills of over $25 billion. Yukos says this is punishment for the political ambitions of its jailed boss, Mikhail Khodorkovsky.

See article

Russia's government went after another private company for back taxes. **VimpelCom** faced a demand for $158m for taxes in 2001. Some suggest that the move against the country's second-largest mobile-phone operator is aimed at Mikhail Fridman, a part-owner. The oligarch is said to have made enemies on high.

Sprucing up

Colgate-Palmolive announced a four-year restructuring plan that will result in the shedding of some 4,400 jobs, 12% of its workforce. The American consumer-goods firm, which faces stiff competition from Procter & Gamble and rising raw-material costs, issued its first profits warning for nearly ten years recently.

DaVita, the world's fourth-largest dialysis provider, agreed to pay $3.1 billion for the American operations of Sweden's **Gambro** to become the biggest kidney-treatment firm in the United States. DaVita will now service some 96,000 patients at more than 1,200 sites.

Pascal Lamy, until recently the EU's trade commissioner, won the European Commission's backing for his candidacy as **director-general of the WTO**. He will run against a Brazilian, a Uruguayan and a Mauritian for the post, which falls vacant in September.

The transatlantic trade spat over state aid for **Airbus** and **Boeing** looked set for a hearing before a WTO panel after top trade representatives from both sides refused to give any ground. The United States made an initial complaint about government subsidies two months ago, prompting an immediate counterclaim by the Europeans.

Double jeopardy

Larry Silverstein, a property developer, won a court battle to force some insurers of the **World Trade Centre** in New York to recognise the September 11th attacks as two separate events. Nine insurers are expected to appeal against the decision, which could force them to pay out up to $2.2 billion. In a previous case with another group of insurers, a jury decided that the destruction of the twin towers was a single event.

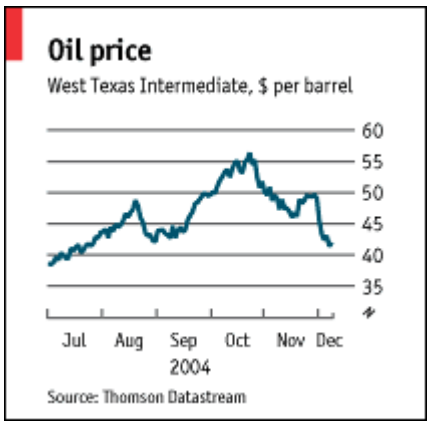
See article

Bruce Wasserstein, chief executive of **Lazard**, and Michel David-Weill, the chairman, suspended a long-running feud over the flotation of the investment bank. Mr David-Weill extended the deadline for the initial public offering to the end of 2005 but said that Mr Wasserstein must resign if it does not go ahead by then.

Credit Suisse unveiled a long-awaited restructuring aimed at improving its faltering performance. The Swiss bank said that it would integrate its troubled investment-banking unit with the rest of its banking operations to improve “focus”. It also hoped to float Winterthur, its insurance unit, after bidders failed to offer the right price.

A little cheaper

The **oil price** neared a five-month low as OPEC ministers prepared to meet in Cairo. Falling prices may tempt the cartel to scale back quota-busting production that it hoped would control soaring fuel costs. Earlier, rumours had abounded that OPEC would change its target price for oil from $22-28 a barrel to around $40 some time next year.



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Russia

The challenger

Dec 9th 2004
From The Economist print edition

Vladimir Putin takes on democracy, the West and all-comers

THE drama playing out in the streets of Ukraine in recent weeks has been gripping in its own terms. But its bigger significance for the West lies north-east of Kiev, in Russia. As the tide moves towards a presidential election victory for the opposition leader, Victor Yushchenko, on December 26th, the efforts of Russia's president, Vladimir Putin, to thwart him have looked ever more cack-handed. But they have also depressed those who still hoped that Mr Putin's Russia might move, slowly and tortuously, on to a path leading to political liberalism—and that he might prove an ally not a foe of the West.

As if Russia's intervention in Ukraine were not enough, the Kremlin's anti-western rhetoric has also risen. In an excess of hypocrisy even by Soviet standards, Mr Putin and his foreign minister, Sergei Lavrov, have accused the West of meddling in Ukraine in order to destabilise the region (see article). This week Mr Lavrov attacked the Organisation of Security and Co-operation in Europe, whose monitors declared the Ukrainian election fraudulent three weeks ago. Mr Putin then widened the field of assault by criticising Iraq's interim government and its plans to hold elections next month.

Even as political confrontation with Mr Putin has been building, the Yukos affair, which has been playing out since the arrest last year of the oil company's chief executive and biggest shareholder, Mikhail Khodorkovsky, has moved towards a denouement. Under pressure from gargantuan tax demands, Yukos is heading for bankruptcy. Its main oil assets are going to fall into the hands of Gazprom, the state-controlled gas company. This confirms that Russia under Mr Putin is no longer—if it ever was—on a clear path towards economic liberalism, either. In short, Ukraine, bellicose noises from the Kremlin and the Yukos saga all make it timely for the West to reappraise the direction in which Mr Putin is taking Russia—and to re-evaluate its policies towards him.

The boss

That Mr Putin is more of an autocrat than a democrat has been clear ever since he became Russia's president in 2000. Yet after the chaos of the Yeltsin years, many hoped that he would at least bring order, a respect for property rights and the rule of law—and that, in time, these might permit the institutions of a liberal democracy to take root. Such hopes led many European leaders to reach out to Mr Putin, and refrain from criticism over matters as the war in Chechnya, human rights or press freedom. In 2001 America's George Bush famously looked into Mr Putin's eyes and got a feel for his soul—and found him straightforward and trustworthy. As recently as last year, Mr Bush declared that freedom and the rule of law prevailed in Russia.

In truth, hopes that political pluralism might emerge in Russia were dashed even before Mr Putin's party swept to a two-thirds majority in Russia's lower house of parliament, the Duma, last December, and before Mr Putin himself was overwhelmingly re-elected in March. His snuffing out of all independent television and most independent newspapers, his hounding of wealthy businessmen (the “oligarchs”) who crossed him, and his rigging of elections all testified to the controlling instincts that one might expect in a former KGB officer. His connivance in the attempt to steal Ukraine's presidential election, his interference in Abkhazia, a Russian-sponsored part of Georgia, and in Moldova, and his support for the dictatorship in Belarus show that he applies these instincts not just in Russia but across the former Soviet Union, the

break-up of which he has publicly regretted. Worse, his instinctive response to criticisms of Russian policy in its near-abroad has been to relapse into general hostility to the West. The West, in turn, has become frostier.

Economic illiberalism too

That left the economy as the one remaining area of hope for change. It has grown strongly under Mr Putin, thanks mainly to the good luck of sustained high oil prices, but helped too by sound macroeconomic policies. Foreign investors, forgetting that they were badly burnt by Russia's default in 1998, have flocked back. But the imminent demise of Yukos and the evidence that Mr Putin is more interested in reasserting state control over the economy than in pursuing economic liberalisation are making many pause once again.

This is not to say that Mr Khodorkovsky or the other oligarchs are saints. There was a case for putting right some of the wrong done in the privatisations of the 1990s that created the oligarchs, for instance by imposing a windfall tax on them and their companies. But the attack on Yukos, the best-run and most western-looking of Russian companies, was the worst cure of all: capricious, selective and motivated by politics not the rule of law. Fears that it might presage attacks on other companies seem confirmed by this week's news of an abrupt tax claim on VimpelCom, a telecoms firm.

Worse, it seems increasingly clear that the assault on Yukos was motivated in part by the desire of Mr Putin's associates in the Kremlin to enrich themselves. One of the least appealing features of Mr Putin's Russia has been a rising tide of corruption. Businessmen in Moscow say that, far from Mr Putin's new order helping to squeeze out corruption, it is now more pervasive than in the worst of the Yeltsin years. Corruption lies at the heart of many of Russia's most intractable problems, from the poor state of the army, to the war in Chechnya, to its ineffective policing and counter-terrorism. Mr Putin has admitted that many Russians might fear the police more than they do criminals. But his efforts to tackle corruption have been half-hearted at best—and, because he has fostered more state control and little respect for the rule of law, he has created precisely the conditions in which corruption thrives best. Meanwhile, the pro-business reforms promised for his second term are largely in limbo.

The conclusion is inescapable. Far from being a political and economic reformer who runs an admittedly flawed but still recognisable democracy, Mr Putin has become an obstacle to change who is in charge of an ill-managed autocracy. The question is, what can the West do about it?

The short answer is, not much. However ineffectual Mr Putin's foreign policy looks after Ukraine, his authority at home is unchallenged. Indeed, there is now talk of his finding some way to run for a third term in office (see article). Moreover, compared with the Yeltsin period, when Russia depended on the IMF, the West has few economic or financial levers to pull. Instead, its growing dependence on Russian energy may actually be putting some levers into the Kremlin's hands.

Even so, firm recognition that Mr Putin is going in the wrong direction is much better than meek acquiescence. Western leaders have been encouragingly robust over Ukraine, rebutting Mr Putin's moans of interference. They can do more to help pro-democracy forces in Russia, especially the non-governmental organisations that are increasingly being harassed. They should extend no favours to Russia in its negotiations to join the World Trade Organisation; nor should they indulge Mr Putin as he prepares to preside over the G8 summit in Moscow in 2006. It may not be time to talk of a new cold war—Russia is not the threat that the Soviet Union was. But it is time to see Mr Putin as a challenger, and not a friend.

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Pay for performance

Running out of options

Dec 9th 2004
From The Economist print edition

The idea of relating top executives' rewards to their shareholders' remains a good one

IT SEEMED like a good idea at the time. Align top executives' pay with the performance of their firms and all will be uplifted—shareholders' returns and managers' returns too. What's more, there seemed to be a simple tool to do this: share options. Award managers the right to buy shares at a certain price, then when their efforts pushed the price above that level they would make a profit, just like the shareholders.

That was in the late 1980s and early 1990s, and for a decade or so the idea seemed to hold good. The longest bull market in corporate history gave managers and investors alike huge rewards. But the years since the stockmarket crash in 2000 have made it clear that something was badly wrong with this system. The rising tide of the market had, as it were, lifted all boats; when that tide receded not all those boats fell to earth with a thump. Indeed, some boats didn't fall at all. In each of the three years from 2000 to 2002, shareholders in America's S&P 500 companies lost between 9% and 22% of the value of their assets. Yet the average total remuneration, including option gains, of the CEOs of big American companies was higher in 2002 than it was in 1999 and 2000. What had happened to the idea of pay as a reward for performance?

The fundamental error was to put most of the burden on stock options. Share prices rise for a host of reasons that have little to do with the performance of the company's managers—especially in a raging bull market with half-crazed speculators searching irrationally for the next big gain. And when share prices move sharply on shifts in actual and projected corporate results, and managers control the timing and presentation of those results, the temptation to manipulate the figures to show them in the best possible light can prove irresistible.

Finally, there was little downside to the stock-options strategy. Managers were often allowed to reprice their options so that they never showed a loss, and typically they were able to sell them after a short vesting period, enabling them to reap passing short-term gains and removing much of the options' power to motivate longer-term performance. On top of this, shareholders were often unable to see that executives' total returns were still riding high when theirs were not because managers to some extent controlled the information that their companies disclosed about their (often very complicated) remuneration packages. By and large, corporate philosophy on disclosure was “the less the better”.

Slowly the veil is being lifted from shareholders' eyes (see article). William Donaldson, the chairman of America's Securities and Exchange Commission (SEC), said last week that “we have to strive to get that information [on executive pay] in understandable and complete form”. Last month CalPERS, America's biggest pension fund, adopted a plan to “tackle abusive executive compensation” which includes submitting a proposal to the SEC next year for greater transparency of compensation packages. Does this then mark defeat for proponents of the principle of pay-for-performance as more and more firms reveal the extent to which the truth has been “Pay Without Performance”—the title of a recent book by two American law professors, Lucian Bebchuk and Jesse Fried?

The power and the pay

Not necessarily, for the idea remains essentially sound. Even the highest-paid executive is still motivated by pay—if not for the sake of further filling his pocket then for the prestige it gives him among his peers.

What is needed is further refinement of pay schemes that have relied too heavily on stock options. The urge to do this could be boosted next year if, as seems likely, American companies have to “expense” their options—ie, put a value on them in their accounts. That they have not had to do so until now has made options superficially “free” to the company issuing them, another dangerous aspect of their allure.

Stock options may still have a role to play if most of their windfall element can be eliminated, and executives' ability to offload them in the short-term is constrained. But other approaches too look promising. In Germany, companies are deeply wedded to the idea of annual cash bonuses. Tied to the right targets these can be effective. Three-quarters of Britain's FTSE 100 have schemes which give executives shares, but then only allow them to sell these shares after a number of years, and only then if the firm meets minimum performance standards relative to its rivals. Such “restricted” stock should be able to focus managers' minds on the medium to long term.

Whatever scheme is adopted, the only way that shareholders can judge whether it is really working and executives are being rewarded only for a job well done is if pay and performance figures are disclosed, transparently and in full. Big investing institutions should demand more such disclosure. And if that does not work, regulators should require it.

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The United Nations

Blaming Annan

Dec 9th 2004
From The Economist print edition

Calls for the secretary-general to resign over the oil-for-food scandal are premature

Getty Images

Get article background

LAST week *The Economist* gave Kofi Annan, the United Nations secretary-general, three pages in which to set out his case for sweeping reforms of the world body (see article). We did not think that was the moment to reflect on the campaign of vilification being mounted against him by his detractors in the United States. But it was not only courtesy that stayed our hand. The mounting calls in America for Mr Annan to resign, as though he were personally responsible for the whole oil-for-food scandal, under which Saddam Hussein skimmed off billions of dollars of oil revenue that were intended to improve the lot of ordinary Iraqis, are premature.

That there was a scandal is not in question. By some accounts, Mr Hussein managed to steal almost $5 billion. (The even more astronomical figures being bandied about came chiefly from oil smuggling that had nothing to do with oil-for-food.) This is a vast scam: its details must be uncovered and the guilty punished. But the details have not yet been uncovered, no charge has been proven, and no official has been convicted of corruption, though some may yet be.

Shouldn't the man at the top go anyway? Mr Annan is not the boss of a firm or president of a country, at whose desk the buck must automatically stop. He is the servant of his political masters. This general rule applied with a particular vengeance in the oil-for-food programme. The UN set up a secretariat to manage the programme, but the members of the Security Council maintained ultimate control. Every contract was scrutinised by a committee of its 15 members. It was not Mr Annan's fault that this committee soon became deadlocked.

Some leakage was deemed inevitable as part of a mechanism that enabled the UN to alleviate Iraq's suffering without letting Mr Hussein wriggle free of sanctions. It now seems that the rip-off was grander than the Security Council had imagined. But the numbers are still vague. Nearly all the allegations are based on an unauthenticated list of some 270 individuals and organisations said to have received oil “vouchers” from Mr Hussein, which they could then sell on for a hefty commission. Among the names on the list is that of Benon Sevan, director of the UN's oil-for-food office. But he proclaims his innocence, and no one has suggested that Mr Annan himself might have been on the take. His son's involvement with Cotecna, a Swiss firm hired to monitor the oil-for-food imports, is a serious embarrassment. Whether it is more than that will not be clear until the findings of the independent inquiry set up with Security Council backing last April are known.

This inquiry, headed by Paul Volcker, a former head of America's Federal Reserve, is expected to deliver its first report in January. Mr Volcker is a man of unquestioned integrity who has been given access to all relevant UN documents. Mr Annan has promised to make his findings public. If this investigation finds Mr Annan guilty of corruption or gross mismanagement, he should certainly be made to pay the price.

Until then, he should be allowed to get on with his job. There are times when an organisation's head should resign even when he is innocent, because the accusations alone are enough to bring the organisation into disrepute. This is not yet one of those times. Many of Mr Annan's accusers are not friends of the UN. Wishing the organisation ill, they are using him as a means to castigate it. Most governments continue to express their confidence in Mr Annan. Innocent until proven guilty is not a bad rule, even at the United Nations.

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About sponsorship

The EU, China and the world

Too soft a touch

Dec 9th 2004
From The Economist print edition

Lifting its arms ban on China will do the EU no credit

AP

Get article background

FOR European governments, which pride themselves on the civilising effect of their “soft power”, these are heady days. The European Union has been helping to broker a deal to win the protesters on the streets of Kiev the freer and fairer election that all Ukrainians were robbed of last month. Next week, despite misgivings, the EU will give Turkey, another large and strategically important neighbour, a date to open talks on eventual membership and thus, it is hoped, every reason for its mildly Islamist government to stay the democratic course.

Bringing stability to its own backyard is no longer the limit of Europe's ambition. This week brought a summit with China, the EU's newest “strategic partner” and a recipient of increasing amounts of European investment and trade. Next week officials from Britain, France, Germany and the EU will start their diplomatic arm-wrestling with Iran over ways to put a permanent end to that country's dangerous nuclear dabbling. And Europe's diplomats are not the only ones seeing action. From Sierra Leone to Afghanistan, from Bosnia to Iraq, Europe's soldiers are giving its diplomacy a harder military edge in increasingly far-flung places. Yet for all the economic and political clout at its disposal around the world, Europe can also be shamefully feeble about where to apply it.

The Europeans should at least be admirably tough on human rights, you might think. Earlier this year European ministers agreed a set of conditions for Myanmar's nasty regime to be seated for the first time, as the Association of South-East Asian Nations wished, at October's biennial ASEM (Asia-Europe) meeting. Yet Myanmar rudely cocked a snook, the Europeans went to the summit anyway and the final declaration was disgracefully silent on the junta's continued ruthless suppression of democracy.

Yet it is over China that the Europeans have got themselves into the biggest tangle. It has long pressed the EU to lift its 15-year-old arms embargo, imposed after the 1989 killings of democracy campaigners in Beijing's Tiananmen Square and elsewhere. France, keen as anyone to compete for a larger share of the lucrative China market, has long lobbied hard for the ban to go on the grounds that it is outdated, anachronistic (lumping China with miscreant regimes like Myanmar, Sudan and Zimbabwe) and not the way aspiring strategic partners should be treating each other. Now France has got its way. At their summit on December 8th, the EU gave China the “positive signal” it had been looking for. The ban is expected to go soon, though the exact date remains to be decided.

Yet lifting the ban sends out entirely the wrong signal. China's human-rights record is still poor. Many of those jailed in 1989 are still there. Earlier this year Chinese officials were hinting, in conciliatory fashion, that at least decrees governing arbitrary detention could be abolished, opening the way for China to ratify the UN's Convenant on Civil and Political Rights—as the EU has pressed it to do. But the Communist Party decided it still needed this tool of repression. And with France and then others pressing so hard for the arms ban to go, what need was there for human-rights concessions anyway?

The ban covers defence technology and weapons, and lifting it would be a strategic error, not just a political mistake. Behind China's military modernisation is a determination to recover Taiwan, which it regards as a renegade province, by force if need be. Turning push to shove would pit China against America, which is pledged to help Taiwan if it is attacked. Shortsightedly, some Europeans don't think Taiwan is much of their concern. Yet if America, which has lobbied strenuously for the arms ban to stay,

were ever to find itself facing off against a China equipped in part by its European allies, the transatlantic alliance could be that war's first casualty.

Not good enough

Those Europeans who fought to keep the ban in place are now mounting a rearguard action to strengthen the EU's broader code of conduct on arms sales. Licences are meant to be denied where equipment might be used to abuse human rights, commit aggression, upset a regional balance or harm the interests of friends and allies. But the EU code is not binding. Governments interpret it differently, especially where technologies have civilian as well as military uses—just the sort of communications and radar technologies that China's armed forces need. And it is unlikely to reassure Congress, which may put up new barriers to transatlantic defence co-operation for fear that China will be a knock-on beneficiary.

All of which leaves China sitting pretty: it is giving nothing in return for the lifting of the arms ban, and can expect the continuing row to exacerbate tensions between Europe and America. The Europeans, meanwhile, are left looking like a bunch of naughty schoolchildren, squabbling over whether to lift the embargo quickly and get the bad news over before America's president, George Bush, visits Europe in February, or wait till his back is turned. None of this is calculated to convince others, such as Iran with its nuclear ambitions, or Russia over Ukraine, that Europe can defend its own interests, let alone take a position of principle and stick to it.

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Europe's housing market

Lifting the roof

Dec 9th 2004
From The Economist print edition

The best way for the euro zone to boost demand is to deregulate its mortgage markets

A DAY rarely passes without the euro area being urged to push ahead with structural reforms to boost its dismal growth rate. This debate tends to focus on supply-side measures, such as making labour markets more flexible. These changes would be welcome, yet a big part of Europe's problem is weak demand, because households save so much. Awkwardly, labour-market reforms that reduce job protection or social benefits are likely to depress spending in the short term. One way to boost both economic efficiency and spending in the euro area would be to shake up its over-regulated mortgage markets.

Research by the OECD has found that variations in the growth of consumer spending among countries in recent years can be explained largely by differences in mortgage finance. In America, Britain and Australia, the ease of borrowing and the availability of housing-equity withdrawal have played a big role in translating gains in house prices into spending. In the euro area consumer spending is less sensitive to rising house prices. *The Economist's* global house-price indices show that, with the exception of Germany, house prices have been rising as fast in the euro area as in America (see article), but this has not resulted in extra spending and less saving.

Not only is saving high in the euro area, but interest rates are also a less effective tool in supporting demand in a downturn than in America or Britain. In those countries, interest rates affect the economy largely through the housing market. But the euro area's overly regulated and uncompetitive mortgage market blunts the power of interest rates. Most people have fixed-rate mortgages, but unlike in America where home-owners can refinance their mortgages, this is either forbidden or expensive in most euro-area economies, so home-owners rarely enjoy the benefit of falling interest rates, and capital gains cannot be turned into cash.

Loosen up a little

This newspaper often lectures America for excessive borrowing and too little saving; surely we are not suggesting that Europeans should adopt its profligate ways? Yes, we are, but only in part. Just as debt can be too high, it can also be too low. Borrowing is not always bad: it can improve economic efficiency by allowing people to smooth consumption over their lifetime. The problem in America is that debt has grown too rapidly, and saving is dangerously low. There is ample scope for European households to borrow more and save less without getting into America's current economic mess.

Households' debt amounts to almost 90% of GDP in America, compared with only 50% in the euro area. America's household-saving rate has fallen to only 0.2% of annual income, compared with more than 10% in the euro area. This reflects the euro area's less-developed mortgage systems, which make it harder to borrow. In France and Italy the typical mortgage has been for 70% and 55% respectively of a home's value and has to be repaid over 15 years. In America 90% loans are common for a period of 30 years. In some euro-zone countries, the size of loans is limited by law, in others a lack of competition restricts the range of mortgages. High costs for buying and selling homes (over 15% of the price in France and Belgium) discourage owners from seeing them as a liquid asset, and so also blunt the effect of house-price gains on spending.

Liberalisation to encourage competition and innovation in the mortgage market, along with action to

reduce transaction costs, would make monetary policy more effective, as well as help to boost spending, at least initially. And in contrast to unpopular labour-market reforms, voters are unlikely to oppose such measures. But what about the European Central Bank's worry that such reforms could exacerbate housing bubbles and economic instability? Deregulation must be done carefully, with adequate supervision to discourage too much risk-taking by lenders. But the blame for housing bubbles usually lies with excessively loose monetary policy, and monetary policy would remain firmly in the ECB's control. Surely the ECB should prefer to drive a well-engineered Porsche with care, than a clapped-out old banger that responds slowly and uncertainly to the accelerator or the brake. Cars don't cause accidents: drivers do.

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Northern Ireland

May the worst men win

Dec 9th 2004
From The Economist print edition

Why everybody must hope that Northern Ireland's extremes come to power

PA

IN ONE way, Northern Ireland's peace process is at a familiar stage. The powers that will determine the province's future—the governments of Britain and Ireland and Northern Ireland's main political parties—are on the brink of a deal. These talks, like so many previous ones, have faltered on the matter of how unionists can be sure that the IRA has given up its arms. Unionists want photographic evidence that the IRA has handed in its weapons. The IRA regards that as public humiliation (so do the unionists, which is why they want it). Television reporters appear every night in front of closed doors behind which they say last-minute talks are continuing. Tony Blair and Bertie Ahern, Ireland's prime minister, make optimistic announcements and the province's politicians then undermine them.

But in two ways, things are very different this time around. First, all the parties to the talks are confident that a deal will eventually be done, and that Northern Ireland's democratic institutions will be restored—if not this week, then sometime soon. Second, it is generally assumed that when the province's devolved government is restored it will be run by two men who bear much of the responsibility for the bitterness and violence in the province over the 36 years since the Troubles began, and who have dedicated their lives to fighting each other's community and cause—the Reverend Ian Paisley (above, left), head of the Democratic Unionist Party (DUP), and Martin McGuinness (above, right), Sinn Fein's chief negotiator, who used to be Northern Ireland's education minister and is believed once to have been head of the IRA.

How is it that the province's worst men are reaping the benefits of the peace process? Because, sadly, the peace process has consumed the better ones. John Hume, the leader of the moderate nationalist SDLP, deserves much of the credit for getting the Good Friday Agreement signed, but his party has been overtaken by Sinn Fein, whose links to violence and hard-line stance against unionism appealed to those who suspected the moderates of selling out.

On the unionist side, David Trimble, head of the Ulster Unionist Party (UUP), which at the time was the biggest unionist party in the province, took the risk of signing the Good Friday Agreement and trying to take his community with him. It was a gamble that did not pay off for Mr Trimble personally. He became the first chief minister under the new dispensation for devolved government, but was defeated by Mr Paisley's DUP in elections in the province a year ago. And the main reasons for his defeat were Sinn Fein's failure to deliver on decommissioning IRA weapons and the constant stream of fire and brimstone Mr Paisley poured on him for dealing with the devil and betraying his community.

Nice stuff, power

Now Mr Paisley is doing just what he condemned Mr Trimble for (see article) The reasons seem to be the usual cynical ones. Mr Paisley's party had jobs in the devolved government before it was suspended, and acquired a taste for power. The prospect of taking office as unionism's champion appears to be an appealing one. And so Northern Ireland's people face the unappealing prospect of being governed by its two most destructive extremes.

Yet this, ironically, is why it could work. A deal done between the DUP and Sinn Fein is more likely to stick than a deal done between the UUP and Sinn Fein: when Mr Trimble was trying to keep the government going, there were always more extreme people—dissenters within his own party as well as

Mr Paisley—trying to undermine him. There is nobody more extreme than Mr Paisley. Nobody outdoes him in virulent passion. Nobody surpasses him in violent rhetoric. The reason why Mr Paisley seems a most unsuitable first minister for such a sensitive place is also the reason why a government run by him and Mr McGuinness is, bizarrely, and tragically, Northern Ireland's best chance.

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Letters

Dec 9th 2004
From Economist.com

The Economist, 25 St James's Street, London SW1A 1HG
FAX: 020 7839 2968 E-MAIL: letters@economist.com

Miseducation

SIR – You foster misconceptions about the education-finance case in New York ("Who needs a bad teacher when you can get a worse judge?", November 27th). First, you fail to note that New York state's highest court began by interpreting the state constitution and giving elected officials a year to devise a reform plan consistent with this interpretation. In New York, as in other states, the courts became directly involved in education finance only when elected officials refused to act. Moreover, the New York courts stepped in immediately after elected officials missed their deadline to avoid the drawn-out process that has taken place elsewhere.

Second, you fail to mention that the cost per pupil of education in New York City is much higher than in most other districts because it has one of the highest concentrations of poor students in the nation and operates in one of the highest-paid labour markets. After accounting for this, the link between inputs and outputs is anything but "vague" in New York state: districts that spend more have better performance.

William Duncombe
John Yinger
Syracuse, New York

Forward-looking business

SIR – Chief executives and corporate boards may be left in the dark if they focus on only a few indicators of their company's success ("Corporate storytelling", November 6th). A recent survey by Deloitte and the Economist Intelligence Unit found that management and boards of directors focus far too much on financial results that represent lagging indicators of past performance. We believe they should pay far more attention to non-financial factors such as customer satisfaction, product and service quality, operational performance, and employee commitment—leading indicators of future performance that firms can use to navigate confidently toward a sustainable future. We also encourage management to communicate with stakeholders about these indicators in quarterly and annual reports.

Boards must venture into a new space equipped with the best experience they can muster. There will be disappointments and mistakes. But the other choice is hardly appealing—continue flying in the dark and risk missing the bigger picture altogether.

William Parrett
Chief executive
Deloitte Touche Tohmatsu
New York

SIR – You say that three-quarters of respondents to a survey by *The Economist* were under increasing pressure to report non-financial data to shareholders but believed that the indicators they used were inadequate to inform markets. Britain's government missed the opportunity to rectify this through the operating and financial-review regulation, due to come into force some time next year. While it includes a requirement that listed companies issue social and environmental data "to the extent necessary", it provides no guidance on what indicators to use. Unfortunately, the government's cowardice will perpetuate a situation whereby business fails to factor in issues of long-term sustainability and therefore ensuring that investors remain ill-informed for the foreseeable future.

Deborah Doane
Corporate Responsibility Coalition
London

Blood sports

SIR – You imply that naive Americans believe that our "sports stars are puritanical role models" ("Definitely out of bounds", November 27th). Professional athletes in America, while admired for their physical gifts, are generally thought of as greedy and self-indulgent at best and prone to violent behaviour at worst. You fail to note that the player most strongly penalised for his actions in the incident in question has a history of suspensions by the NBA.

Chris Daly
New York

SIR – As an avid sports fan it has become increasingly difficult to pass on the family passion to our 12-year-old son. Most of our time is taken up not in discussing formations or tactics but in explaining what Viagra is used for and why it is wrong for a player to come to blows with fans. Sport is compromising its future—our children, the fans of tomorrow.

Deborah Samuelson
Staten Island, New York

More means less

SIR – Lexington cheers the greater diversity of America's media (November 27th). However, I exercise caution in welcoming "new media". Much of it has an embarrassing record of inaccuracy. The *Drudge Report*, which led the charge against CBS's blunder over George Bush's service with the Texas National Guard, has never provided a benchmark for accuracy. But technology deserves plaudits. With tools like internet news search engines I can access a wide diversity of information from hundreds of newspapers worldwide. This is a reason to celebrate. It is more than a mere changing of the guard.

Chad Gould
St Petersburg, Florida

No alternative

SIR – You neglect to mention some of the political aspects of an alternative minimum tax (Economics focus, November 27th). I suspect that George Bush will keep the AMT in place. First, it is a "blue-state tax" to a large degree because one of the deductions that the AMT denies is that for state- and local-income levies. These are heaviest in New York, Massachusetts, Illinois and California, and lightest or non-existent in both Texas and Florida, among others.

Second, the AMT can be relied on to generate many more Republican voters in time. I know a good number of younger families who never really resented America's tax system until they were hammered for the first time by the AMT as their incomes rose. The law of unintended consequences is very much alive.

Louis Knapp
Rockville, Maryland

Gone to ground

SIR – You ask where are all the Zimbabweans? ("Where have all the people gone?", November 27th). To sleep and to rural oblivion, battered by Robert Mugabe's physical violence and economic deprivation, frightened and cowed with nowhere to turn. Even Britain, our former friend and colonial power, seems distracted by far more important issues—foxhunting, obesity and smoking—to worry about Zimbabwe. Britain has done little other than to offer partial legitimacy to one of the world's most oppressive regimes by sending out its cricket team to play up and play the game.

Paul Tingay
Harare

Imperious

SIR – Roger McKinney says that “most Americans could not care less whether we are loved or not, as long as the rest of the world respects us” (Letters, November 20th). This aligns us with the political theories of 2,000 years ago. “Oderint dum metuant” (“Let them hate us as long as they fear us”) was a favourite saying of a beacon of democracy, diplomacy and moral values, the emperor Caligula.

Pat Fanning
Blacksburg, Virginia

ONLINE ARTICLES

The following correspondence refers to articles published only online

Corporate comeback

SIR – You argue that corporate America is making a comeback as shareholder activism wanes (”Making the wrong sort of capital”, Economist.com, December 2nd). But “Corporate America” in the sense you mean is a euphemism for the managers of publicly held corporations. The interests of corporate management, contrary to that of shareholders and corporate America, seem to be what is making a comeback.

John Propper
Toronto

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Iran

Still failing, still defiant

Dec 9th 2004 | TEHRAN
From The Economist print edition

AP

In the short run, Iran is getting grimmer. One day the ruling ayatollahs will lose their deadening grip on power. But not soon

Get article background

"THE firing of a bullet into his damned and blasphemous head is an absolute necessity—and how cherished would that bullet's emissary be." Those were the gentle words recently directed by one of Iran's leading editors, Hossein Shariatmadari, at an exiled Iranian television presenter, Manouchehr Fouladvand, who has had the cheek to mock aspects of Islam: shades of the *fatwa* that cast a death sentence on a British writer, Salman Rushdie, cursed for blasphemy in 1989 by the late Ayatollah Ruhallah Khomeini, Iran's supreme leader. A return, then, to the intolerance of the revolution's early days?

Perhaps not. Though Mr Shariatmadari is the influential boss of a state-owned newspaper group, *Keyhan*, which faithfully echoes the thoughts of Iran's conservative clerical leaders, his exhortation is unlikely to be acted on. Since the kindlier Muhammad Khatami became president in 1997, his governments have managed to dampen Iran's fundamentalist ardour, especially on social matters. Women who flout the Islamic dress-code, which still requires their heads (and the rest of their bodies) to be covered in public, are more rarely threatened with a flogging. The law providing for adulteresses to be stoned to death, though still on the statute book, is suspended. A blind eye is still turned to the many thousands of Iranians who tune in to satellite television, though that is still technically illegal.

Nonetheless, Iran's liberals and reformers feel increasingly beleaguered, and voices such as Mr Shariatmadari's are louder and more menacing than they were even six months ago. In that period, says one of Tehran's longer-serving foreign diplomats, "there has been a dramatic change in mood". Bullying militias are again trying—so far without much success—to enforce the old morality. Last month a female MP from the conservative camp suggested that if ten "street-walkers" were executed, "We will have dealt with the problem [of prostitution] once and for all."

More worrying from the liberals' point of view, the reform-minded but disappointingly dithery Mr Khatami has been the lamest of ducks since the ruling clergy and the country's supreme leader, Ayatollah Ali Khamenei, who succeeded Mr Khomeini in 1989, presided over a rigged general election in February when the candicacy of 2,000-plus reformers was blocked. As a result, the new parliament is distinctly

more xenophobic and illiberal than its predecessor. Of its 290 members, more than a quarter share the sort of rabid views expressed by Mr Shariatmadari, and they seem to be mocking Mr Khatami with impunity in his last months in office.

The sole remaining liberal daily newspaper of any weight, *Shargh*, feels obliged to censor itself more rigorously than before for fear of being closed down, as so many of its like-minded counterparts have been. The so-called “red lines” that fence off sensitive issues from discussion are being drawn more tightly. Freedom of expression is diminishing again.

The media have never been allowed to criticise the supreme leader. “But now we cannot attack the judiciary or the Council of Guardians either,” says one of *Shargh's* editors, referring to Iran's 12-strong body, the most powerful in the land, composed of six clergy appointed by the supreme leader and six others picked by the head of the judiciary, himself picked by the leader. It is they who blocked reform-minded candidates from standing for parliament and refused to ratify virtually all the more enlightened bills—nearly half the total—passed by the previous parliament.

Not that mass repression is needed to keep the media, or the Iranian people in general, in line. According to a respected human-rights campaigner, between 2,000 and 4,000 Iranians, including about 30 journalists, are behind bars for political reasons. The reason for the overall figure's vagueness is that many of those incarcerated are in “unofficial” prisons: even their relatives are not told they are there.

In the past few months detentions have swelled of “bloggers” who have set up internet sites, which the state has taken great trouble to block. A number of well-known campaigners for human rights have been prevented from going abroad or arrested on their return. Human Rights Watch, an independent lobby group, said this week that “secret squads operating under the authority of the Iranian judiciary have used torture to force internet journalists and civil-society activists to write self-incriminatory confession letters”.

Downcast in Tehran

The clampdown seems to be working. Many of the liberal and sophisticated professionals of northern Tehran, downcast by Mr Khatami's failure, seem to have withdrawn into a private life behind the walls of their villas. Many are emigrating, at an estimated rate of 200,000 a year, especially to the United States (where there may be 800,000 Iranians), Canada (perhaps the most popular destination), Britain, France and Australia.

Mr Khamenei seems, on the face of things, more dominant than ever. But power in Iran is by no means monolithic. Even the conservatives divide into various strands, from rigid puritans to cautious pragmatists. Some, for economic and strategic reasons, would like Iran to accommodate with the West, even with the United States. Others, loth to stain the revolution's purity, are prepared to accept Iran's isolation, protecting the country from the “westoxification” that has, in their view, corrupted so many Muslim countries. Yet others think they can defend the old morality and the political dominance of the clergy while, at the same time, opening the economy to the West; they invoke a “Chinese model”. Policy may, in the course of the next few years, shift back in a more liberal direction. Or it may not. The future is highly unpredictable.

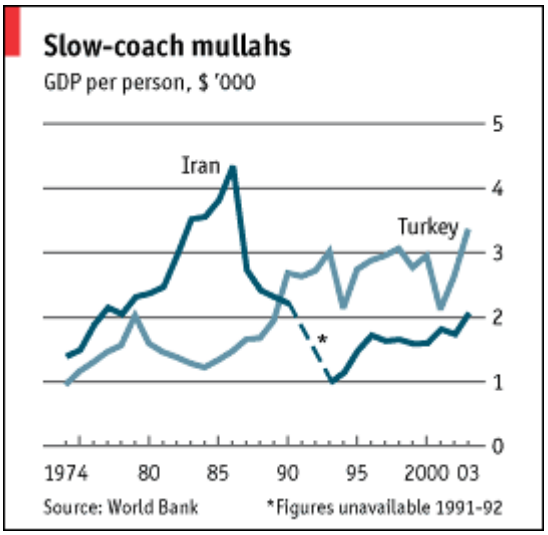
The one thing everyone knows is that Iran is in a jam. Above all, plainly, there is a crisis of legitimacy. Only half of Iranians bothered to vote in February's election; not much more than a quarter of those in Tehran, which embraces at least 8m people, turned out. Western diplomats reckon that barely 15% of Iranians still support the ruling order. The low turnout reflected not just apathy and fatalism, which are indeed strong. Many sour and embittered Iranians consciously decided not to go to the polls as a gesture of protest.

“We've come to a dead end,” says Grand Ayatollah Yusef Saanei, one of a dozen clerics to hold this high rank in Iran but whose liberal views, especially on women's rights, have put him out of favour with the ruling clergy.

According to some reports, disaffection with the regime even among the clergy is spreading. A cleric from an influential religious family, also out of favour with the supreme leader, derides the Council of Guardians for mostly taking “orders and hints from the powers that be”—a euphemism for Mr Khamenei. Most striking of all, sociologists and educators report that religious belief and observance, especially among the young, have slumped since the mullahs took power a quarter of a century ago. Instead of

fortifying the people's devotion, the system seems to have switched many people off the spiritual side of life, inspiring a shallow materialism instead.

In a population of around 70m, one-third are reckoned to be under 14 and two-thirds under 35. Though the economy grew by about 6% last year, it is not expanding fast enough to keep unemployment down. Around 16% are officially jobless, though the real figure may be higher. At about 17%, inflation is rising faster than wages. Though the necessities of life, such as bread and potatoes, are hugely subsidised, the lot of the urban poor, whose minimum wage is around $12 a month, is dire.

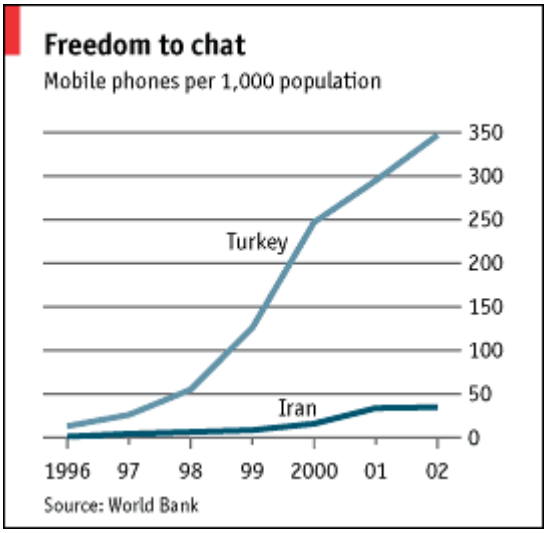


The mullahs have patently failed to revamp an economy that remains distorted by subsidies, closed to competition within Iran or from abroad, locked in the hands either of the state or of state-connected foundations known as *bonyads*, and increasingly reliant on the high price of oil: Iran has about a tenth of the world's known reserves. Barely a fifth of the economy is in private hands. The conservatives have made it hard for the timid Mr Khatami to sell off state firms or open up to foreigners. The merchants of the bazaar, a longstanding pillar of the mullahs' power, still protect their own cartels. Capital flight continues apace. Only four private banks exist (three of them linked to *bonyads* or to the state), with just 4% of the banking sector's assets. Corruption in every sphere of business stunts growth and puts off investors. People mutter about the mullahs' wealth and patronage.

The new parliament has been especially obstructive, preventing, for instance, a Turkish company (“with Zionist links”, so it was bruited) from acquiring a mobile-phone franchise to break the current inefficient monopoly. It has also prevented the opening of Tehran's new airport, because it would have been operated by a Turkish-led consortium—so, in the conservatives' view, imperilling national security. Most recently, parliament has threatened to unpick a big deal with Renault, the French car-maker, to produce a new car.

Without oil at its present sky-high price, Iran's economy would be in wretched straits. Oil provides about half the government's revenue and at least 80% of export earnings. But, once again under the influence of the zealots in parliament, the oil cash is being spent on boosting wasteful subsidies rather than on much-needed development and new technology.

Comparisons with neighbouring Turkey are instructive, painfully so to Iranians who look beyond their own borders. Before Iran's revolution, Turkey was behindhand on practically every count—foreign direct investment, income per head, GDP growth. Now the reverse is true. More noticeably, Turkey's politics have become far more open, its (still patchy) human-rights record has improved, its media and civil society are much bouncier than in Iran. Turkey has had a female prime minister; since the revolution, Iran has not even had a woman minister. Turkey is moving ahead, and may even join the European Union; Iran is falling behind.



Other regional comparisons further irritate Iranians. The Qataris have far outstripped them in exploiting the huge gasfield they share. Tiny Dubai, across the Gulf, now draws in much more foreign investment: Iranians go there for banking, for trade (and sanctions-busting) and for fun. Farther along the Caspian shore, Azerbaijan, with American know-how, is developing its oilfields far more dynamically; Iran's productivity rate has plummeted.

In the face of such gloomy contrasts, Iran cannot make up its mind whether to co-operate with the perfidious infidel West to save its economic skin and strengthen its security, or to keep its Islamist soul unsullied. That dilemma is at the heart of the present wrangle over nuclear power.

Why they want nukes

For all its recent sense of failure, Iran still yearns to be acknowledged as a leading power, even *the* leading power, in the area. In some respects, it is not doing badly. Iraq and Afghanistan, neighbours on either side, have—in Iranian eyes—been humiliated by occupation by the Great Satan. Iraq, its old foe, is a mess. Turkey apart, Iran is a giant that looks steadier on its feet than some of its neighbours. And if ramshackle Pakistan, to the east, can have a nuclear bomb yet remain a crucial ally of the West, why shouldn't Iran have one too?

Publicly, it says it does not want one. But with vast and cheap supplies of gas and oil, few observers think Iran really needs nuclear energy. The International Atomic Energy Agency (IAEA), the UN's nuclear watchdog, has found no irrefutable evidence that Iran is building a bomb. Last week, the head of Iran's Atomic Energy Organisation, Gholamreza Aghazadeh, chirpily told *The Economist*, “We've never even thought about it.”

But a mass of circumstantial evidence, along with a tangle of lies, omissions and evasions in the face of the agency's inquiries, has convinced just about every independent analyst that Iran has indeed been trying to build—or at least have the capacity to build—a nuclear bomb, in violation of the Nuclear Non-Proliferation Treaty, under which it promised not to do so. (It has also proclaimed the extension of its Shahab-3 missile's range from 850 to 1,250 miles, within striking distance of Tel Aviv.) Israel, an undeclared nuclear power that has never signed the NPT, and whose right to exist has never been recognised by Iran's ruling mullahs, is particularly exercised by the prospect of an Iranian bomb—and has hinted it might hit a range of would-be nuclear targets across Iran.

In the end, it is all about national pride—and high-stake risks, tortuous and deliberately time-consuming negotiation, fine calculations, deception and bluff.

These are the options:

• The leading three European countries (Britain, France and Germany), which have been negotiating since last year, manage to persuade Iran to stop its uranium-enrichment and plutonium-reprocessing programmes that could have a military as well as civilian purpose, and allow intrusive checks by the IAEA, in return for trade agreements and other sweeteners. But the best guess is that the Iranians will still spin things out, while beavering away at getting the wherewithal for a bomb.

• A “grand bargain” (tentatively mooted by John Kerry) with the Americans, who would end a quarter of a century of hostility, lift their economic sanctions now in force, and forge a complete rapprochement. This would also entail Iran co-operating against terrorism, opening up its economy, improving human rights and recognising Israel (the ayatollahs say they would accept a Jewish state once they are satisfied that the Palestinians do, too). Few people think this option will be taken up.

• If both those options come to naught, it is possible that Iran will be referred to the UN Security Council for its breaches of the NPT and could then face worldwide sanctions. As things stand, China and Russia are likely to block such a resolution, but it is conceivable that Russia could change its mind, and China abstain.

• If the blockage continues, either Israel or the United States might bomb Iran's nuclear sites, just as Israel knocked out Iraq's Osirak reactor in 1981. It would be harder, as Iran's sites are scattered, and some are deep underground. A concerted attack would probably set back Iran's nuclear schemes by several years or more—but not end them. And it would risk bloody retaliation against Israel and America.

As things stand, Iran will probably attain the capacity to make a bomb and, after an Indian-style period of “strategic ambiguity”, break out of the NPT. It would be unlikely ever to use this weapon. But it would be safer, perhaps, from the sort of attack launched on it by Saddam Hussein 24 years ago.

No sign of the ayatollahs falling, then?

The American administration's hope that sanctions and other pressures will eventually force a change of regime in Tehran looks, in the foreseeable future, forlorn. And an Israeli or American attack might well have the adverse effect of rallying Iranians to their rather unpopular regime.

Otherwise, only three things could jolt Iran out of its present torpor of stagnation and depression. One is the presidential election due in May. Another, further down the road, is a dramatic slump in the oil price. The third is the possibility of a Gorbachev figure emerging from within the clerical establishment to open up the deadening political and economic system. At present none of these three possibilities looks likely, at least not in the short run.

The presidential candidate, so far undeclared, who has aroused most debate—and cautious hope among some of those seeking change—is Ali Akbar Hashemi Rafsanjani, a former president who now heads the Expediency Council, an influential mediating body. He is generally dubbed a “pragmatic conservative”. Some businessmen think he would help open the economy; others demur, considering him the epitome of the rich mullah with fingers in every pie but no real yen for the market.

He is undoubtedly a cunning fellow with a penchant for intrigue at home and abroad—Americans have not forgotten how he humiliated them during the Iran-contra affair. He is also unpopular among the people at large, scoring dismally in the general election earlier this year. But the ruling mullahs have their ways of promoting—and blocking—candidates. The presidency, as Mr Khatami has shown, can anyway be emasculated. But if Mr Rafsanjani got it, he might make a difference.

Is there a Gorbachev elsewhere among the mullahs? It is an unlikely prospect, but the inner workings of Iran's clerical establishment are mysterious and supremely opaque. Mr Khamenei's standing, such as it is, has fallen—even, it is said, among the clergy. The opposition, at present, is numb. Only if the price of oil, say, halved, and the economy really dived would the anger and frustration well up again and bring people out on the street. And so long as that does not happen, the Iranians are miserably stuck with what they've got.

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Correction: Gareth Evans

Dec 9th 2004
From The Economist print edition

Our table last week of members of the UN High-Level Panel on Threats, Challenges and Change referred to Gareth Evans as a former tourism minister of Australia. He is, of course, a former foreign minister. Our apologies. This error was corrected online.

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Energy policy and the environment

Heating up at last?

Dec 9th 2004 | NEW YORK
From The Economist print edition

Science Photo Library

The Bush administration may yet oversee a proper debate about energy policy

EVEN though he was once a Texas oilman, energy has so far been something of a disaster for George Bush. It has brought him nothing but grief from virtually every side of the debate. Even world oil markets have turned against the president: prices have soared in his first term.

Mr Bush's best known energy decision remains brusquely pulling out of the Kyoto protocol—a deeply flawed climate-change treaty that the Senate would never have accepted. But most of the administration's attention has centred on something else Mr Bush announced soon after taking office: America's supposed “energy crisis”.

The idea that America can ever strive for any form of energy independence is bogus: though it sits on just 3% of the world's oil reserves, it consumes a quarter of global oil production. But Mr Bush asked Dick Cheney to come up with a new energy policy. The task-force the vice-president set up, what with his ties to Halliburton and his unnecessary secrecy, soon turned into a public-relations fiasco.

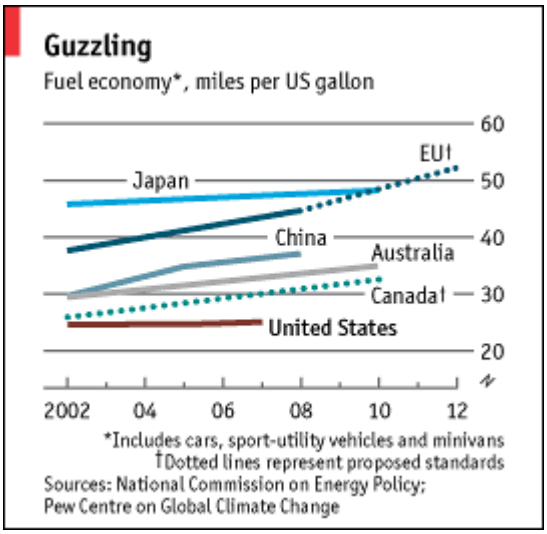
Mr Cheney's final plan called for massive subsidies and tax breaks for the oil, gas and nuclear industries and, most controversially, for oil drilling in Alaska's Arctic National Wildlife Refuge (see article). This thrilled the energy industry, but an absurdly pork-laden $100-billion energy bill failed to get through Congress.

As for climate-control policy, this is another fine mess. Having rejected Kyoto, Mr Bush proposed a toothless combination of voluntary programmes and “emissions-intensities” targets (where the carbon content is measured in relation to the economic output of the company or industry concerned). The absence of federal policy has left states to set their own standards, and industry with a growing number of conflicting rules.

This sham prompted Senator John McCain to offer up a climate bill with real teeth. His joint effort with Senator Joe Lieberman, a Democrat, called for a mandatory carbon-emissions cap and a flexible trading system. The bill won the support of 44 senators this year—but the cost of implementing it scared the energy lobby and it also failed to pass.

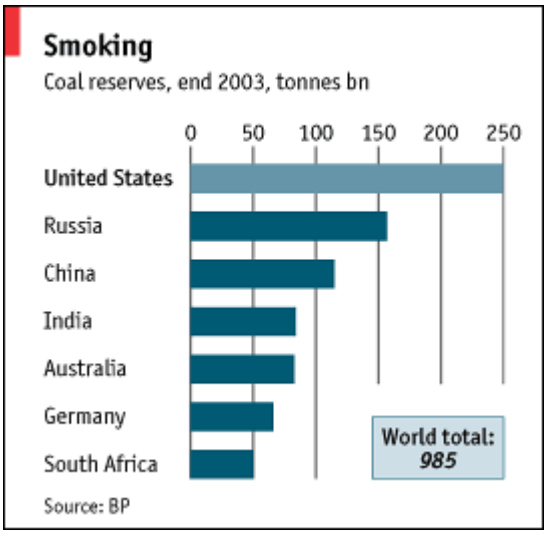
This has left neither side of the energy debate particularly happy. The “on your bike” crowd is still fuming about Kyoto; the “keep on pumping” group is depressed by the chaos. As Lee Raymond, the chairman of Exxon Mobil, scoffed recently, America has no national energy policy. By international standards, the United States still remains unusually dependent on dirty forms of energy (especially coal) and its cars and trucks still have distressingly low fuel-efficiency levels (see charts).

Mr Bush, however, emboldened by the stronger Republican majority in the Senate since the election, is now keen to have another go. The controversial proposal to drill in the ANWR will be tacked into a special “budget resolution” bill in February. That loophole would allow the provision to pass with just 50 votes, not the usual 60 (insiders reckon they have 53 votes). Meanwhile, a slimmer energy bill will be pushed through later in the spring.



Will that bill end up being just as larded with bacon as the current version? Possibly not. First, the administration seems far keener on reining in spending after its re-election. And second, serious debate is beginning about energy policy in general and climate change in particular.

This week saw the publication of the final report from the National Commission on Energy Policy (NCEP), a bipartisan group of heavyweights from business, government, environmental groups and academia. It is arguably the first serious practical attempt to deal with the various problems America faces.



•On energy independence, the report tilts towards the industry position. It calls for an expansion of global strategic petroleum reserves, which would ease the impact of oil disruptions. And it agrees that the government should help to pay for a pipeline to bring Alaska's vast (and clean) natural-gas reserves to market.

•On fuel efficiency, the NCEP tilts toward the greens. It wants the current Corporate Average Fuel Economy (CAFE) law that Detroit detests to be strengthened. But it also calls for $3 billion in government incentives to help hybrid-electric and advanced-diesel vehicles.

•On coal, the NCEP accepts the political reality that America will continue to rely on the stuff unduly; but it wants government money to be focused on “clean coal” technologies, such as coal gasification and carbon sequestration.

•On the thorniest issue of all, climate change, the NCEP boffins' solution is a compromise between Messrs Bush and McCain. They agree with Mr McCain that carbon curbs must be mandatory and must be linked to a trading of permits; but they suggest targeting emissions intensities, as Mr Bush wants, on the basis that anything broader might slow down the economy. And the NCEP plan calls for a “safety valve” to ensure that the costs of the permits never rise above a predetermined level (the boffins suggest a starting-price ceiling of $7 per tonne of carbon).

Critics from both sides are already carping about this. Jim Connaughton, a White House adviser on greenery, sniffs at the mandatory targets—though it is hard to see how a voluntary system would really change behaviour. From the other side, greens are worried that the safety valve is too low. The Kyoto protocol would supposedly have obliged American firms to spend $51 per tonne of carbon to clean up their act (albeit by 2010); McCain-Lieberman set a level of $9-16. Greens fear that under the NCEP's

scheme, too many polluters might find it cheaper to buy permits than clean up their mess.

The truth is that nobody knows how much the cost of cleaning up would be. Bill Reilly, a co-chairman of the NCEP and head of the Environmental Protection Agency under George Bush senior, points out that, if the safety valve proved too low, it could simply be raised over time. Besides, greens often claim that the American economy is so energy-inefficient that it is littered with cheap carbon savings.

The Bush administration's response to the report has been lukewarm, but there is more political momentum behind the NCEP's ideas than you might think. America's divisions on energy policy are often more regional than partisan. For instance, it is coastal Republican governors such as Arnold Schwarzenegger, George Pataki and Mitt Romney who are leading the way on placing mandatory curbs on carbon emissions from cars and power plants.

There is also now a celestial voice in energy policy. Conservative religious groups are increasingly concerned about the issue. *Christianity Today*, the magazine of Billy Graham's evangelical movement, has just run an editorial arguing the moral case for action on climate change. As Mr Lieberman says with a smile, “The earth is, after all, a faith-based initiative.”

Mr Bush's religiosity is well known; however, he also frequently talks about himself as an environmentalist. That position is much mocked. But he now has a chance to start changing American attitudes towards energy. The NCEP report is a much better starting point than that old pork-laden energy bill.

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Alaska and oil

One state's free lunch

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For Alaska, as for Arabia, oil wealth is not all good

AMERICANS react in two ways to the oil price in the United States. For most, $2 for a gallon of petrol is a scandal, and there have been gripes galore that the huge increase in energy prices over the past five years has slowed down the economy. And then there is the view from Alaska.

Last January, the state's budget, which is financed almost entirely from oil royalties and taxes, was $361m in the red. Now the 2005 budget shows a $340m surplus—a figure that will rise if oil stays above $35 a barrel for any length of time. Each $1 increase in the price of a barrel of oil pours $60m into the state's coffers.

And it could get even better, regardless of what happens to the oil price. For the past quarter-century, the oil industry has been clustered around Prudhoe Bay on Alaska's north coast (see map). Now millions of acres of federal land are being opened up. Last month, for instance, the Bureau of Land Management approved oil exploration across 9m acres in the National Petroleum Reserve, a vast area reasonably close to Prudhoe Bay, which was set aside in 1923 as a naval oil reserve. It supposedly contains 9.3 billion barrels of oil. Other schemes are underway farther west along the Arctic Ocean.

The big prize, however, is to the east of Prudhoe Bay: a 1.5m-acre patch in the Arctic National Wildlife Refuge (ANWR). Oil companies have long had their eyes on the ANWR, which has estimated reserves of 10.4 billion barrels. But they have been stopped by greens intent on preserving the virgin landscape and a wildlife population that includes caribou, polar bears, musk oxen and sky-darkening flocks of birds.

George Bush proved unable to open up the ANWR for drilling in his first term; now it is back on the agenda (see article) and this is welcome news in Alaska for politicians of all sorts. This year's Senate battle between Lisa Murkowski, the Republican incumbent (daughter of Frank, the long-time senator, now governor), and Tony Knowles, a Democratic former governor, degenerated into a brawl over who could get the oil rigs into the ANWR fastest. Miss Murkowski won the race, largely because she convinced Alaskans that Mr Knowles would be too close to anti-drilling “outside” Democrats.

It is not hard to see why Alaskans love oil. It provides jobs, makes state taxes unnecessary and gives everyone an annual cheque from the oil-financed $29 billion Permanent Fund; this autumn, the pay-off was about $900 for each resident. But it has also had unanticipated effects.

For instance, Gregg Erickson, an economist in Anchorage, reckons that the state's population of about 600,000 is 10% higher than it would be without the Permanent Fund. The extra people include “cheque-seekers” who move to the state, people taking jobs created by the dividend cheques, and even the extra children that Alaskan families have, thanks to that $900 breeding incentive.

Then there is the paradoxical cost—pointed out by Ashley Ahrens, another Alaskan economist—that, because Alaskans pay no state taxes, they haven't a clue how much their government costs. The state budget has been in deficit year after year. Meanwhile, it is hard to get money to finance schools or roads because that means tapping the Permanent Fund and cutting those annual cheques.

Lastly, greens are no longer just complaining about the direct effects of the drilling on Alaskan wildlife, but also about the indirect effect the oil will have on global warming. Climate change, they claim, is particularly relevant to Alaska. Roads around Fairbanks must constantly be repaired as the permafrost (permanently frozen soil) beneath them melts; coastal villages face flooding; trees are being killed by unusual insect infestations. Dominique Bachelet at Oregon State University thinks that the Alaskan tundra may well vanish by the end of this century.

It is dishonest to pretend that the 10.4 billion barrels of oil in the ANWR will tip the planet's climate one way or another: the United States whistles through twice that amount in a single year. But it may be similarly dishonest for Alaskans to treat their federally supported tundra as their own personal piggy bank.

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New York politics

Next trial, please

Dec 9th 2004 | NEW YORK
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New York's second-most-ambitious politician is running for governor

EVEN Eliot Spitzer's critics acknowledge he has a good nose for a ripe target. He made his name by digging his claws into such unloved people as the mutual-fund industry (after the stockmarket crash), the absurdly greedy head of the New York Stock Exchange and the perpetually unpopular insurance industry.

Now he has found a target held in even lower esteem: New York state's government. On December 7th, to the surprise of no one, Mr Spitzer announced that he would run, as a Democrat, for governor. Even though the contest is not until 2006, polls immediately put him in front of the Republican incumbent, George Pataki (though one, by Quinnipiac University, puts both men behind Colin Powell, the departing secretary of state, who has not scotched rumours that he may run).

The reasons for New York's disgust with its government in Albany take a long time to list. They include some of the highest taxes in the nation, budgets that are never passed on time, a huge deficit, a low credit rating and a massive lawsuit paralysing the schools.

Originally elected in 1994, Mr Pataki is now the longest surviving governor in America. He has a long record of outsmarting more glamorous foes, such as Mario Cuomo and Rudy Giuliani, and two years to improve his standing. But his powers seem to be waning. His vetoes are ignored by the Democratic state assembly; only this week, they overturned his veto of July against increasing the minimum wage. He may not even run again: some think he will be given a post in the Bush administration, allowing him an honourable exit.

Conveniently for Mr Spitzer, Mr Pataki has done nothing to groom a Republican successor. Mr Giuliani, who shared Mr Spitzer's love of the cameras and of bashing white-collar criminals, feuded with Mr Pataki while he was mayor of the Big Apple. His last official foray into politics was a run for the US Senate, aborted because of prostate cancer. But his attentions are now firmly on the presidency.

Some had supposed that Chuck Schumer might run for governor. The Democratic senator had raised a suspiciously large amount of money (almost $30m) for his easy re-election in November. But on November 15th, Mr Schumer announced he would remain in the Senate, in return receiving congratulations, no doubt heartfelt, from Mr Spitzer.

By moving so early, Mr Spitzer offers the equivalent of a pre-emptive blow. His fund-raising machine roared into action two days after his announcement, with a $1,000-a-plate dinner. But much can happen in two years. Mr Spitzer, who has long railed about conflicts of interest, will now face some between his current job and the one he aspires to hold. Inevitably, he will be asked why, if he believes Albany is really a sinkhole, he has not prosecuted it as aggressively as he has private industry.

Then there is the question of Mr Spitzer's relish to tackle the structural problems in Albany. Fred Siegel, a senior fellow at the Progressive Policy Institute, thinks there is plenty of room to make quick headline-grabbing improvements: a set of ethics rules, for instance, or cleaning up the state authorities responsible for transport, construction and so on. But many deeper problems revolve around the public-sector unions and other entrenched lobbies, who like the status quo and whose support Mr Spitzer now seeks.

Unlike Mr Giuliani, who relished combat both in court and in the mayor's office, Mr Spitzer likes to talk tough but then make deals. That worked fine when he was dealing with stockbrokers and insurers; but the groups that dominate Albany need a Giuliani-style clobbering. Winning the election may be the easy bit for New York's crusading attorney-general.

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Intelligence reform

Centralised intelligence?

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A new spy chief, but with less power than first hoped

"THE test of a first-rate intelligence," said F. Scott Fitzgerald, "is the ability to hold two opposed ideas in the mind at the same time, and still retain the ability to function." That test might apply to the intelligence reform that passed through Congress this week. Its opposing notions are that the spying system must be streamlined and centralised; and that it needs to encourage greater competition from maverick ideas. Hopefully, the intelligence system will retain the ability to function.

The intelligence-reform bill was unquestionably a political success for George Bush. For a month, Republicans in the House held it up, demanding more immigration controls, and arguing the bill could impede the flow of intelligence to soldiers on the battlefield. The rebellion challenged Mr Bush's authority in Congress and raised doubts about his post-election promise to seek bipartisan co-operation (the bill could have passed weeks ago with Democratic votes, but Speaker Dennis Hastert refused to put it to a vote without more Republican support). By allaying worries about the Defence Department, Mr Bush won over some Republican critics and improved his own credibility. But will the bill improve intelligence?

America has 15 intelligence agencies with a $40 billion budget. There have long been calls for greater co-ordination, most recently from the September 11th commission. The bill heeds these calls by adding two centralising forces to the convoluted spying web: a new counter-terrorism centre to "connect the dots" and a national intelligence director.

The counter-terrorism centre exists. It was set up by executive order this summer. The new law may reduce its flexibility a little. But the bigger changes could come from creating a new intelligence director.

In theory, a single supervisor should improve accountability and make it easier to move resources around. But as George Tenet, a former director of the Central Intelligence Agency, has argued, an intelligence director with only general supervisory powers could weaken co-ordination not strengthen it. No one, including the president, will heed someone without direct operational responsibilities.

Mr Tenet's warning may sound like someone defending a status quo that did not work. But the real power of the new director will come not from the law, but from the president's ear, and success in turf battles, especially with Donald Rumsfeld at the Pentagon. Given that the concession to win Republican assent was a line in the law saying the new director will "not abrogate the statutory responsibilities" of the defence secretary or other cabinet members, do not expect huge changes.

But the bigger question is whether more co-ordination is the solution to recent intelligence failures anyway. The September 11th commission showed that many of the problems were operational failures by individuals. There were certainly organisational problems of co-ordination with the Federal Bureau of Investigation, but none were insurmountable—and anyway the FBI is being reformed separately (the new law barely touches it). Similarly, intelligence failures in Iraq were failures of "group think" not organisational structure.

Perhaps the new director will listen more to agencies other than the CIA. But as John Hamre, the president of the Centre for Strategic and International Studies, has argued, more co-ordination is likely to mean fewer opposing views, just when you want to encourage those rare souls who got Iraq right. Perhaps the best that can be said for this new law is that America's intelligence services are so sclerotic that a shock at the top—any shock—is needed. More sensible reforms can be worked out later.

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A soyabean crisis

Rust never sleeps

Dec 9th 2004 | LITTLE ROCK
From The Economist print edition

The spores of wrath have descended on a southern crop

AP

Like a hurricane

A CLOUD of deadly spores from a faraway continent looms over the rural South. It can destroy millions of acres of crops. While local politicians panic, Washington fiddles. A B-movie matinée? Alas, no; Arkansas, right now.

Asian soyabean rust, a lethal fungus that attacks soyabean plants, landed recently in the United States. Scientists believe that one or more of this year's many hurricanes carried the spores from South America to the states on the Gulf of Mexico. Once there, the spores travelled more than 300 miles a day, infecting nine states in just over a month. Although this year's soyabean crop is already in, the disease could ruin next year's harvest, especially in states like Arkansas, which ranks first in the South and ninth in the country in producing soyabeans.

The disease blights more than soyabeans. The spores also attack kudzu (a leguminous creeper that has become a plague in parts of the South), blackeye peas (a staple of southern cuisine), lima beans and some clovers. Winter cold will not kill the fungus; instead, the spore clouds will shift to the warmer southern states and roll out next year during the early growing season.

So far, no soyabean variety can withstand the rust. At best, resistant plants are six to eight years away. Although the rust can be managed with three fungicides, it has to be spotted early. Treating the disease could eat up a soyabean farmer's entire yearly profit. If the rust becomes uncontrollable, then a state's entire soyabean crop could be destroyed in just a few days.

Since Arkansas has an early planting season, scientists say the rust could find a firm footing in the state. There it could generate a massive load of spores and travel to prime soyabean acreage in the mid-west, destroying most of the American crop. In 2003, the United States supplied 40% of the world's soyabean trade. That same year, the crop value exceeded $18.4 billion. In Zimbabwe, South Africa, Paraguay and Brazil, Asian soyabean rust has destroyed up to 80% of the plants.

Arkansas's congressmen and senators, alarmed that their state may be the gateway for such havoc, recently asked for $715,000 in federal funds to fight the disease. The usually overgenerous United States Department of Agriculture (USDA) has not yet decided whether to help. Many farmers fear that the government knows the disease is uncontrollable, prefers not to spend money on a losing battle, and will leave them instead to fend for themselves.

Yet in a farming state like Arkansas, which grew nearly $800m worth of soyabeans last year, farmers cannot afford to dither while the USDA decides. They can see the spore-cloud coming, even if the men in Washington can't.

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Lexington

Fixing the American dream

Dec 9th 2004
From The Economist print edition

George Bush needs to spend some of his political capital on a subject that has split the right

THIS summer Arnold Schwarzenegger wowed the Republican convention with his invocation of the immigrant dream. He celebrated the fact that a scrawny boy from Austria could grow up to become governor of California. He celebrated the openness of American society. And he celebrated the Republican Party's continuing commitment to immigration. “To my fellow immigrants listening tonight,” he said, to roars of approval, “I want you to know how welcome you are in this party...We encourage your dreams. We believe in your future.”

Wonderful stuff. But unfortunately political conventions bear about the same relationship to reality as Mr Schwarzenegger's films do. The reality is that immigration is a nightmare for the American right. The current immigration system is about as badly broken as it can be, with 8m immigrants residing in the United States illegally and another 1m illegals arriving every year. But George Bush has no chance of fixing it unless he is willing to get into a fight with his own rank and file.

Ever since he won re-election, Mr Bush has come under intense pressure to do something about immigration. Politicians from the border states paint a picture of mounting anarchy: shoot-outs with smugglers, bodies decomposing in the desert sun, bankrupt hospitals. (There have been around 2,000 deaths on the border in the past five years.) Businessmen complain that they no longer want to face a choice between breaking the law and going out of business. And homeland-security chiefs argue that they are wasting time policing economic migrants.

There are growing signs that Mr Bush is preparing to respond to this chorus. Last January he sketched out a plan to grant temporary-worker status (for three-to-six years) to millions of “undocumented aliens” while also making it easier to get citizenship. The plan got little traction at the time. But this time round it looks as if the White House is more serious about reform.

Karl Rove, the president's main strategist, has identified immigration reform as a top priority. Colin Powell, the outgoing secretary of state, has told the Mexican government that “the environment has improved significantly for immigration reform”, a message that was reinforced by Mr Bush himself during his recent visit to Chile. He has also discussed the subject at some length with his nemesis-turned-ally, John McCain, who represents immigration-obsessed Arizona and is the sponsor of an even more liberal plan than Mr Bush's in the Senate.

Mr Bush's problem is that no subject under the sun—not even abortion—divides the American right quite as viciously as immigration. The two main groups are restrictionists, who want fewer legal immigrants, a tougher border and sterner treatment for illegals, and liberalisers who want to bow to economic reality and regularise the current situation, through guest-worker programmes and the like. The Republican congressional caucus is split down the middle between liberalisers such as Senator McCain and restrictionists like Congressman Tom Tancredo of Colorado. But the split cleaves the entire conservative movement in two. Compare the liberal *Wall Street Journal* with the restrictionist *Washington Times*, for example; or the libertarian Cato Institute with the tougher Centre for Immigration Studies.

The restrictionists have made it clear that they don't give a fig about Republican unity when it comes to immigration. It was one reason why they derailed—albeit temporarily—the bipartisan intelligence-reform bill. And they clearly have the power to make Mr Bush's life difficult. Mr Tancredo's anti-immigration caucus has more than 70 members, up from just 15 three years ago. Many of the most powerful chairmen in the House are either overtly or covertly on his side. And conservative talk radio is in a permanent lather about immigration. “Their amnesty plan was dead on arrival when they sent it to Congress in January,” says Mr Tancredo, “and if they send the same pig with lipstick back to Congress next January, it will suffer the same fate.”

Is the fight worth it? Mr Bush has several other fish to fry—most notably reforming the tax system and Social Security. And he needs to cultivate good relations with a Republican leadership that puts an inordinate emphasis on party unity. But for all that he needs to push ahead with reform, fisticuffs or no.

Optimism is the right way

The most important reason why the reform is worth it is that the current situation is unsustainable. The status quo has always been an economic nonsense. Large chunks of the American economy is dependent on illegal immigrants: they supposedly account for three in four agricultural workers at some times of the year. But since September 11th immigration has been a threat to national security as well. Millions of migrants currently live in a shadow world where the government cannot trace them.

But the fight could well be worth it for political reasons too. It would burnish Mr Bush's reputation as a reformer who is willing to tackle hard subjects—even if it means alienating his fellow conservatives. It would advance his vision of turning the Republicans into a majority party. (Despite restrictionist fears that the newcomers will all become Democrats, the Republicans have almost doubled their share of the Latino vote in less than a decade—from 21% in 1996 to about 40% this year.) And it would demonstrate once again where Mr Bush stands in the conservative universe—in the optimistic tradition of Ronald Reagan rather than the pessimistic tradition of Mr Tancredo.

Nobody should underestimate the difficulty of reforming immigration. Mr Bush will have to form bipartisan alliances with Democrats (much as Bill Clinton had to form bipartisan alliances with Republicans over NAFTA). He will also have to strike a delicate balance between enforcing the law and creating a ladder to permanent citizenship. But the rewards for persevering will be huge—not just a better Republican Party but a better America.

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The future of Mercosur

A free-trade tug-of-war

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From The Economist print edition

Next week's summit in Brazil is unlikely to bring a South American common market much closer to reality

IT IS hard to know which is more fashionable, bashing Mercosur or exalting it. In some ways, things have never looked better for the incipient common market, which consists of Brazil, Argentina, Uruguay and Paraguay. Uruguay's presidential election in October replaced a Merco-sceptic with the Merco-phile Tabaré Vázquez. Now the three biggest economies will be led by leftish politicians keen on regional integration (tiny Paraguay has little choice). They enjoy healthy economic growth and their budget and foreign-exchange policies are similar.

Yet on the eve of next week's summit in Ouro Preto in Brazil, where Mercosur assumed its current form ten years ago, there is more snarling than celebration. Argentina is putting up barriers to Brazilian exports. Brazilian rice growers have blocked shipments from Argentina and Uruguay. Talks on a free-trade agreement with the European Union ran aground in October in part, say critics, because Mercosur could not present a decent offer. “The consensus around the building of Mercosur is starting to crumble,” says Alfredo Valladão of Sciences Po, a French university.

Mercosur shapes its members' foreign policies but not yet domestic ones. Argentina's president, Néstor Kirchner, champions Mercosur partly to distinguish himself from predecessors who sought “carnal relations” with the United States. Luiz Inácio Lula da Silva, the Brazilian president, sees leadership of the group as a way of adding to Brazil's weight in the world. “Integration” is supposed to encourage stability and democracy in a region that has known too little of both (see article).

But practising integration is harder than talking about it. Mercosur is an odd quartet. Brazil dwarfs its three partners, but is not rich enough to subsidise them nor willing to surrender chunks of sovereignty, as Germany has done to promote European union. Argentina is too small to play the strong sponsoring role of France, and sometimes adopts the wariness of Britain. All four members are prone to economic crises, which they spread to each other, triggering every-country-for-itself reactions. The new generation of leaders may make matters worse. Keen as they are on Mercosur, they are even more eager to expand the state's role in development, which is hard to reconcile with freer trade and uniform rules.

The countries have dealt with their differences by constructing an “imperfect customs union”. The “common external tariff” has 800 exceptions, says Roberto Giannetti da Fonseca, trade director of FIESP, São Paulo's main industry federation. Exporters to Mercosur often pay it twice, once on entry and again at the border with the destination country.

More worrying, the union is getting more imperfect over time. On top of agreed exceptions for cars and sugar, Argentina has recently piled tariffs on Brazilian televisions, shoes and other goods. Brazilian businessmen blame Europe's unwillingness to open its agricultural market in part on Argentina's protectionism. And now Argentina wants automatic safeguards to block spikes in imports.

This has sparked a near-rebellion by Brazilian businesses against both Mercosur and the Brazilian government. They accuse the government of pursuing deals with other developing countries at the expense of trade with the EU and the United States, the biggest markets. Perhaps Mercosur should simply become a free-trade area, allowing Brazil to negotiate on its own, muses Mr Giannetti.

To Argentines, the solution is “more Mercosur”, while Brazil, they complain, strives for less. It resists, for example, recognising its partners' food-quality standards, says Beatriz Nofal of Eco-Axis, a consultancy in Buenos Aires. While railing against Argentina's barriers it provides cheap finance to its own exporters, a practice that allegedly destroyed the Argentine bus-body industry in the mid-1990s. Brazil is the most reluctant ratifier of Mercosur resolutions, half of which have not been made law. To become a proper common market, says Ms Nofal, Mercosur must harmonise investment and trade incentives and sales-tax regimes—a view largely shared by Argentine officialdom.

So Brazil's government is caught between placating Argentina and its own disgruntled businessmen. One answer is “a massive injection of structural funds”, say Brazilian diplomats, which could be used to boost Argentina's competitiveness. Brazil's state-owned development bank, BNDES, would probably be the main source, giving Brazil a more Germanic profile. Brazil expects the summiteers in Ouro Preto to move towards eliminating double-charging of the external tariff, endorse equal treatment for all bidders on government contracts (the first mutual recognition of standards within the group), and approve procedures so the new dispute-resolution tribunal can function.

That would be progress, but the disfiguring of Mercosur will continue. Brazil will consider Argentina's demand for safeguards while clinging to its own system of trade and investment incentives. Ms Nofal thinks three destinies are possible: perfecting the customs union en route to making it a true common market, abandoning that ambition in favour of a free-trade area, or, most likely, muddling through as now. In other words, championing Mercosur and bashing it at the same time.

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Mexico's budget wrangles

Show us the money

Dec 9th 2004 | MEXICO CITY
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President and Congress are locked in a struggle over the budget

WHEN the Institutional Revolutionary Party (PRI) ran Mexico, budget-making, like everything else, was pretty simple. The PRI president drew up a budget. He handed it down to Congress. And the massed ranks of the PRI deputies acclaimed it and voted for it.

The process began to depart from this choreography after the PRI first lost a congressional majority in 1997, but since Vicente Fox of the National Action Party (PAN) became president in 2000 the dance has disintegrated further—and the past few weeks have seen it develop into a monumental stand-off between the presidency, the main political parties and, likely soon, the Supreme Court as well.

The trouble began after Mr Fox presented his $158 billion budget last month. Lawmakers from the PRI and the left-of-centre Party of the Democratic Revolution (PRD), which together dominate the lower house of Congress, used new powers allowing them to “modify” the budget to reallocate about 2% to their own pet projects, at the expense of funding for government ministries which could cost thousands of federal jobs. Mr Fox refused to accept what he called these “grave errors”, and last week returned the budget to Congress, with 64 new “observations” of his own. The PRI has vowed to reject these, which will land the budget back on Mr Fox's desk, probably on December 13th.

He threatens then to take the dispute to the Supreme Court. Technically, it is just a legal argument about whether the president has the right to veto the budget. But Leo Zuckerman, a political scientist at CIDE, a Mexico City university, argues that the stand-off could have long-term implications for deciding whether Mexico should be “a presidential system, or a congressional, parliamentary system”.

In the short term, however, Mr Fox's credibility is at stake. Congress has stymied all of his major reform proposals over the last four years, leaving him looking like a lame-duck president with a third of his term still to run. Caving in on the budget would make him look more irrelevant than ever. Yet until a Supreme Court ruling, early next year, Congress's budget would apply; and even if the court backed Mr Fox, the opposition would almost certainly still have the two-thirds majority needed to overturn his veto.

Which is why he has little else left to do, besides being seen to assert the prerogatives of his office. He asserted another one this week by firing the Mexico City police chief and the commissioner of a federal police force over the feds' failure to prevent the public lynching of three of their colleagues, two of whom died, on the city's outskirts last month. That made Mr Fox look active; but it also looks partly like a gambit to weaken the capital's mayor, Andrés Manuel López Obrador of the PRD, the current favourite for president in 2006.

The only good news for Mexico is that in the past, such a budget battle would have shaken the international markets. But this time there has been hardly a murmur. The umbilical link with the American economy and Mr Fox's continuation of his predecessor's prudent macroeconomic policies seem to have reassured investors that Mexico can survive even a violent political storm without going off course.

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South American summitry

Fraternity at 3,300 metres

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Fleeting visions of a continent-wide union

THE thin air of Cusco, mountain capital of the ancient Inca civilisation, is conducive to giddiness. Leaders of eight countries gathered there this week to declare the founding of a "South American Community of Nations" which is to include all 12 of the continent's countries, encompassing 360m people and a GDP of $1 trillion. "We are here to give flesh, bone, soul, heart and life to the dream of [Simon] Bolivar," declared a starry-eyed Alejandro Toledo, Peru's president, remembering the liberator of South America. Eduardo Duhalde, a former president of Argentina who is now the political face of the Mercosur free-trade area, invoked another dream: "Our mirror will be the European Union, with all its institutions." Specifically, that means—in the fullness of time—a single currency, passport and market along with a common parliament.

The inspiration comes largely from Brazil, which has long dreamed of becoming the pre-eminent member of a united South America. The idea has a practical core. The summit continues a series that started four years ago to draw up plans for building bridges, roads and energy connections among South American countries. Brazil's president, Luiz Inácio Lula da Silva, and Mr Toledo announced in Cusco an agreement to build a road linking Brazil to the Pacific through Peru. The community's second leg is a series of free-trade agreements linking Mercosur to the five Andean countries. The main business of Cusco is to wrap all this up into a political package along with commitments to co-operate on security, poverty and the like.

But the new community is a fractious one. Three of the four Mercosur presidents did not come, a notable omission since their group is the most ambitious attempt so far at regional integration in the Americas. Ecuador's president also had more pressing business at home. Chile, which pulled out of the Andean Community in 1976, will not rejoin it because its tariffs are too high. Andean countries in general trade far more with the United States than with their new Mercosur partners. Perhaps the most useful result of the Cusco summit will be informal talks between Presidents Ricardo Lagos of Chile and Carlos Mesa of Bolivia. The two countries have been feuding since Bolivia lost its coastline in the 1879-83 war with Chile.

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Bolivian municipal elections

The parties are over

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A reshaped political landscape

Reuters

A daunting degree of democracy

THE candidates from the big parties tried all the tricks they knew. They campaigned on everything from bicycles to horseback; they handed out promises and electoral bribes, from chocolates and pasta to beer and bags of cement.

But the voters were not convinced. Though only preliminary results are in for the 327 mayoral posts that were contested on December 5th, an unprecedented upset seems certain. The political parties that have taken turns to run Bolivia since its dictatorship ended in 1982 have been ousted for their promotion of unpopular free-market policies and privatisation and their tolerance of corruption. The same parties that picked up two-thirds of the votes cast in the last local elections in 1999 may have gained as little as 10% this time.

The change is thanks to Carlos Mesa, the current president. Elevated from the vice-presidency in October 2003, when mobs evicted his predecessor, Gonzalo Sánchez de Lozada, Mr Mesa has sidelined Congress and forced through constitutional reforms. Candidates were allowed to stand as independents, and did so, for newly founded parties or citizens' groups. Indigenous groups were also officially recognised as political entities for the first time. Over half of all Bolivians consider themselves Indians, and many owe their first allegiance to local chiefs.

As a result, no less than 420 political parties and grassroots organisations registered to participate in the ballot, compared with 18 in 1999. Most just fielded a candidate for one particular district, but ballot sheets in some areas were still dauntingly long. Unperturbed, voters sorted wheat from chaff: in most districts the voting polarised between two or three candidates. But nationwide support for three out of the four major parties has melted.

Given their demise at local level, many had thought the power vacuum would be filled by the leftist indigenist Movement to Socialism (MAS). The MAS became the second-largest force in Congress after a surprise upsurge in support during the 2002 presidential elections. Its leader, Evo Morales, a staunch opponent of the orthodox, free-market policies pushed by the unpopular Mr Sánchez, rose to prominence in the mid-1990s, as leader of a labour-union movement pledged to defending coca growers against United-States-backed efforts to eradicate the crop.

And yet the MAS has failed to secure any of the ten biggest cities and may not even win one of the top 20. While its rural support is strong, its total vote looks to have stagnated, at around the same one-fifth that it won in the presidential contest. Even El Alto, Bolivia's poorest big city, the heart of government-toppling riots in 2003, and an obvious MAS constituency, re-elected a centre-right mayor, José Luis Paredes, on his good performance.

All this leaves the political parties in Congress, where they have seats until 2007, in limbo. Mr Mesa had already deprived them of their customary power-sharing, preferring to govern without a fixed block of support than to be tainted by ties to them. An elected assembly to consider wide-ranging reform of the constitution is set for mid-2005. It will have the power to dissolve Congress and call fresh elections—a prospect that must now have sharply improved.

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Peru's terrorism trials

Locked-up Lori

Dec 9th 2004 | LIMA
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A court decision saves the bacon of Peru's president

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CHRISTMAS came early for Alejandro Toledo. Last week the Inter-American Court of Human Rights in Costa Rica bolstered Peru's president by upholding the conviction of Lori Berenson, an American woman who has spent nine years in Peruvian jails on terrorism charges.

Ms Berenson was convicted in 1996 of collaborating with the Tupac Amaru Revolutionary Movement (MRTA), a now-defunct Cuban-style rebel group which later notoriously seized the Japanese ambassador's residence in Lima. She spent nearly three years in solitary confinement in a dimly-lit mini-cell, in a prison nearly 4,000 metres (13,000 feet) above sea level.

Intercession from a host of campaigners, including Amnesty International, may have had some effect: in August 2000, Alberto Fujimori's then-crumbling government decided that the first trial was flawed and ordered a new one. But she was found guilty again in June 2001. Her appeal to the human-rights court was her last hope: she can now expect to sit in jail until 2015.

But while Ms Berenson's lawyers have tried to pick holes both in her conviction and in Peru's draconian anti-terrorist laws, Peruvians never accepted her explanations of how more than a dozen heavily armed MRTA guerrillas sub-let part of the house she had rented in Lima, or about her friendship with two of the outlawed party's leaders. Her marriage last year to Anibal Apari, a former MRTA militant she met in prison, has not won her any sympathy either. The Peruvian media have never tired of replaying images of Ms Berenson at a press conference at which she was paraded shortly after her first conviction, shouting that the MRTA was not a terrorist band but a “revolutionary movement”.

Meanwhile Mr Toledo, whose popularity rating is under 10%, can breathe easier. Had the court ruled in Ms Berenson's favour, he would have faced the choice of going along with it and looking soft on terrorism, or bucking the court and inviting comparison with the undemocratic Mr Fujimori, who briefly pulled Peru out of the court over a similar case involving Chilean members of the MRTA.

Moreover, a ruling favouring Ms Berenson might have given hundreds of jailed subversives from the MRTA and the much larger Shining Path, which killed tens of thousands of Peruvians during two decades of armed conflict, a chance to take their own cases to Costa Rica. All are facing retrials because Peru's Constitutional Tribunal ruled last year that many of the country's anti-terrorism laws, specifically those that allowed civilians to be tried in military courts, were unconstitutional. The retrial of 14 MRTA members began this week. The prospect of terrorists pouring out of jail in their hundreds is a fearful one for Peruvians: even though the country has not suffered any big terrorist attacks in more than two years, nearly 82% of people in a recent poll in the capital, Lima, said terrorism was an “imminent threat”.

That fear owes much to the failure of the biggest case of all: that of Abimael Guzmán, the founder of the Shining Path. His retrial began on November 5th, but ended in a circus, with judges, prosecutors and lawyers fighting amongst themselves. A mistrial was declared on November 15th. That fiasco loomed as the Inter-American Court was deliberating on the Berenson case. Mr Guzmán may be the number-one face of terrorism in Peru, but Ms Berenson, justly or unjustly, is right behind him.

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Hokkaido

Japan's coddled frontier

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Getty Images

Japan's northernmost prefecture is beautiful but economically weak

THE people of Hokkaido, a vast northern island of farms, forests and wilderness, are trying to save two endangered species. One is the red-crested crane, some 800 of which live in the island's eastern Kushiro Marsh. The other is the wingless crane that, along with other bits of Hokkaido's construction sector, once thrived in a habitat awash in government subsidies. But much of this money has dried up since Junichiro Koizumi, the prime minister, slashed the country's public-works budget. And after depending for decades on public money, Hokkaido has few competitive firms capable of exploiting the export-led recovery that has buoyed other parts of Japan over the past couple of years.

Falling even further behind is a sad state of affairs for a region that was once considered Japan's rugged frontier. As with many other rural Japanese, however, the people of Hokkaido, including many who settled here after the second world war, have allowed their destiny to be shaped by the gentle tug of government purse strings rather than the unpredictable pull of market forces. Of course, the region, which accounts for less than 5% of Japan's population but nearly a quarter of its landmass, still has some obvious assets to fall back on. It has plenty of forests, national parks and ski slopes to attract tourists, and offers activities ranging from rafting to digging up potatoes.

Hokkaido is also the closest thing Japan has to a farm belt, producing wheat, meat and the bulk of Japan's dairy products. Its rivers and coastal waters supply plenty of seafood. It is also, for many, a pleasant place to live. Ikkei Matsuda, head of Hokkaido Venture Capital in Sapporo, the local capital, once worked for a big securities firm in Tokyo. He likes the laid back lifestyle in Sapporo, and says he can now live in a bigger condominium, for less money, than anything he could have dreamed about in the nation's capital.

But the island has developed few other advantages over the years, and is now paying the price. The subsidy mentality and its aftermath are most evident among Hokkaido's countless small building firms, many of which have either gone bust or are close to it. These firms, many employing 20 or fewer people, grew up feeding off the public-works budget. Some of the subsidies were delivered through the construction ministry, but the farm ministry also played a big role. Much of its budget was intended to help farmers adjust to the loss of jobs and incomes caused by global competition. Instead of thinking up wise ways to invest these funds, officials used construction projects simply to inject money into rural areas with insufficient regard for the probable benefits.

Hokkaido has little to show for all this public investment. Although it can offer cheap land and labour to national employers—factory wages, at ¥240,000 ($2,300) a month, are one-third less than the national average—it has not made itself attractive to manufacturers. Only a few factories making car parts and electronics have sprouted on the island over the years. And now that Hokkaido realises it needs more of them, it faces stiff competition from elsewhere—not least nearby China.

Thus, even though Japan as a whole is enjoying an investment boom, most of Hokkaido's manufacturing investments have involved expanding existing facilities, not building big new factories. A few parts of Hokkaido—such as the coast south of Sapporo—have been able to cash in on the export-led boom. The rest of the island is still pretty weak.

Bereft of the old subsidies, the small construction firms are turning themselves into farmers, service providers, anything that will help them survive. Private companies are not allowed to own agricultural land in Japan, but a recent rule change allows them to lease land from existing farmers. So one tactic has been for builders to trade in their jackhammers for tractors.

Indeed, many of Hokkaido's recovery plans seem to involve replacing uprooted subsidies with new and more promising varieties of government money. The governor, Harumi Takahashi, once headed the Hokkaido branch of the ministry of economy, trade and industry. METI, once famous for directing Japan's statist industrial policy, still directs plenty of subsidies and tax breaks towards new sectors it deems promising. Part of the governor's appeal, says one local academic, is that voters believed her METI connections would help her tap into these subsidies more skilfully. Biotechnology and information technology investments are bandied about as promising candidates.

In the meantime, the island is counting on tourism to pick up the slack. Last year was disappointing, says an official from METI's Hokkaido branch, because there was not enough snow to attract very many skiers. Tourism also suffered because discount air fares to remote parts of the island went up, after a small regional airline, Air Do, went bust in 2002.

Tourism promoters are now trying to attract more visitors from north-east Asia and Australia. Hokkaido also experimented with daylight-saving time in a few areas this past summer. It hopes that the national government will soon let the entire island adopt it, allowing its long summer days to end even later at night, thus giving tourism a further boost.

Unsurprisingly, some plans to attract tourists involve big subsidies. The biggest is a scheme to extend Japan's bullet train all the way to Hokkaido, using the existing tunnel from the northern tip of Honshu to Hakodate, on Hokkaido's south-western peninsula. The cabinet may endorse funds for such a project this month, when it approves the blueprint for next year's budget. In Hokkaido, they are hoping that their beloved subsidies, like migrating birds, will soon find their way home.

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East-Asian diplomacy

Yankee stay home

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A new form of Asian summitry, which excludes America

WHAT would an East Asian Summit entail? When the decision to hold such a gathering was first announced, at the annual summit of the Association of South-East Asian Nations in Laos last month, no one seemed to know the answer. Ong Keng Yong, ASEAN's secretary-general, had to retract a press release stating that the new grouping was simply a revamp of ASEAN+3, which brings the leaders of China, Japan and South Korea together with their South-East Asian counterparts. The details, he said, were still up for negotiation. But Malaysia, which will host the new club's first get-together next year, has an ambitious agenda.

In a speech in Putrajaya on December 6th, Abdullah Badawi, Malaysia's prime minister, said the summit should lay the groundwork for an East Asian Community, modelled on ASEAN's own plans for integration. The members of the EAC, he suggested, should build a free-trade area, co-operate on finance, and sign a security pact. If implemented, the theory runs, these proposals would transform East Asia into a cohesive economic block, with as much clout as Europe or America.

In fact, some of these schemes are already in motion. China, Japan and South Korea have all signed ASEAN's Treaty of Amity and Co-operation, which commits them to renounce the threat or use of force in their dealings with ASEAN countries, among other things. All three countries have also agreed to negotiate free-trade deals with ASEAN. Thaksin Shinawatra, Thailand's prime minister, has persuaded East Asian countries to buy one another's bonds, to help guard against the depredations of the free market.

But inventing a new acronym and holding yet another summit are unlikely to speed these measures up. For one thing, the new grouping would raise awkward questions about China, Japan and South Korea's relations with one another, which are more fraught, on the whole, than their ties with ASEAN. Indeed, Japan seems to be engaging with ASEAN thanks more to its rivalry with China than to a determination to open its economy. Even within ASEAN, commitment to economic integration is weak. Indonesia, for one, resisted the proposed new summit, for fear it might eventually overshadow ASEAN itself.

When pressed to explain exactly how East Asian Summits would differ from ASEAN+3 meetings, Mr Ong suggested that non-ASEAN countries would be able to host them. That is not as inconsequential as it sounds. Rodolfo Severino, Mr Ong's predecessor, assumes that China will host the second East Asia Summit. Whether it does so or not, China, as the region's pre-eminent economic and military power, will doubtless dominate the proceedings.

In 1990, America shot down another putative pow-wow, dubbed the East Asian Economic Caucus, precisely for fear of losing influence in the region. All East Asia's many other formal talking shops, such as the ASEAN Regional Forum, or the Asia-Pacific Economic Co-operation summit, include America. Even if the proceedings do not amount to much, the new club will give China an unrivalled chance to shine. Which, presumably, is the whole point.

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Intellectuals in China

Under fire, again

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Free expression worries the authorities

Get article background

IN AN Orwellian obfuscation of its role, the Chinese Communist Party's Propaganda Department prefers to translate its name these days as the Publicity Department. But one of its main tasks remains that of issuing secret directives to the state-controlled media telling them what not to report. And among its latest prohibitions is any encouragement for "public intellectuals" in China.

In recent years, the party had become more relaxed about intellectuals. Outspoken academics helped fuel the campus fervour that eventually erupted into mass protests in Tiananmen Square in 1989. But the crackdown, followed a couple of years later by an economic boom, dampened demands for political change. The party began to worry more about unemployed workers and disgruntled peasants, and less about intellectuals—many of whom, anyway, were turning their attention to making money.

More recently, however, the rapid spread of the internet and the increasing commercialisation of the Chinese media have given intellectuals new avenues of expression. A few, including economists, social scientists and lawyers, have become well-known among the chattering classes for their critiques of social ills (though prudently, in most cases, not of the party itself). The term "public intellectuals" has crept into the media, encouraged not least by a Chinese translation last year of "Public Intellectuals: A Study of Decline", a book by an American judge, Richard Posner, examining the role of such commentators in America.

The Propaganda Department lost its patience after a magazine in Guangdong Province, *Southern People Weekly*, published a list of 50 Chinese public intellectuals in September. The market economy, said an accompanying commentary, had caused the rapid marginalisation of intellectuals. "But this is the time when China is facing the most problems in its unprecedented transformation, and when it most needs public intellectuals to be on the scene and to speak out."

If the 50 had been loyal party stooges, all might have been forgiven. But among them were several who are decidedly not, including Zhang Sizhi, a defence lawyer who has argued in the trials of some of China's best known dissidents; Cui Jian, a rock singer whose irreverence has irritated the authorities since his heyday in the Tiananmen era; Bei Dao, a poet who has been forced to live in exile since the 1989 unrest; and Wang Ruoshui (who died in 2002), a senior journalist and member of the party's inner circle who turned dissident. A scathing commentary on the list, published last month by a Shanghai newspaper and republished by the party's main mouthpiece, *People's Daily*, said that promoting the idea of "public intellectuals" was really aimed at "driving a wedge between intellectuals and the party." The window for free debate that opened a crack over the past couple of years, as China's leadership shifted to the "fourth generation" of leaders, is closing again.

Oddly, perhaps, given the supposed indifference of urbanites to politics, two of the bestselling books in China this year have been about the "anti-rightist" campaign of 1957, during which half a million of the party's intellectual critics were persecuted. One of the books, "Past Events Have Not Vanished Like Smoke", was banned by the Propaganda Department. The other, "Inside Secrets of 1957: The Sacrificial Altar of Suffering", is still for sale. Though probably not for long.

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Indonesia

Not United

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Splits in the world's biggest Muslim organisation

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Reuters

Muzadi: moderniser or opportunist?

THE world's largest Muslim organisation is in crisis. Nahdlatul Ulama (NU), which claims about 30m members across Indonesia, is being torn apart by two very public and intertwined disputes—one ideological and one personal—that threaten a permanent schism in the 78-year-old body. Both of them centre around NU's leader, Hashim Muzadi, who was re-elected last week by the NU's quinquennial congress for a second five-year term, and the uses he might make of that term.

Mr Muzadi is a soft-spoken cleric from the NU'S heartland in East Java. He ran as the vice-presidential candidate on the losing ticket of the last president, Megawati Sukarnoputri, in Indonesia's first-ever direct presidential election in July and September. To his supporters he is a moderniser who has brought NU into the 21st century whilst solidifying its financial base and organisational structure. His critics, though, see him as a despot with grand political ambitions who cares only about the elite whose support he needs.

The ideological fight pits Mr Muzadi against a broad coalition of elderly clerics, liberal intellectuals and youth groups. This alliance believes Mr Muzadi has turned NU into a political commodity that is for sale to the highest bidder and has discarded its tradition of rejecting party politics to focus on practical matters, such as its members' education, prosperity and cultural and religious development. As evidence they point to the smart NU offices that have sprung up across the country and the new cars parked outside them, as well as a decline in educational standards at the 7,000 *pesantren* (Islamic boarding schools) which claim affiliation with NU.

This coalition met in October to agree on a programme for NU's future and, more immediately, to convince delegates to the congress to oust Mr Muzadi. They failed. Mr Muzadi was re-elected with a massive majority. Rather than lick its wounds and admit defeat, the anti-Muzadi coalition, which claims the support of the majority of the membership, is fighting back. It is planning an extraordinary congress in March to oust Mr Muzadi. If that fails, it is threatening to form a rival organisation. But complicating this dispute is the bitter personal rivalry between the organisation's leader and his predecessor, Abdurrahman Wahid, one of the leading lights of the campaign to oust Mr Muzadi.

Mr Wahid, who resigned as head of NU when he became president in 1999, lost influence within the organisation when he was unceremoniously impeached in 2001. In recent months this globally respected beacon of moderate Islam has appeared increasingly erratic. The result is that his claim of wanting to return NU to its core purpose and away from party politics rings hollow to many followers. They think him as much a political operator as Mr Muzadi: after all, he used his position to found a party and grab the presidency.

A significant element within NU, while very unhappy with Mr Muzadi, see Mr Wahid as a more destructive force. The depth and permanence of the schism will only be revealed with time. If the Wahid camp cannot rally sufficient support in the next three months, its rebellion is likely to wither rapidly. Conversely Mr Muzadi, who only attracted 21% of NU supporters in the first round of the presidential election, may

find himself leader of a well-funded structure lacking critical mass.

The wider fallout is also hard to predict. While neither faction espouses militancy, there are signs that radical groups could play one camp off against the other for their own benefit. At this stage these ripples are barely visible. If NU descends into all-out civil war, the tide may prove harder to contain.

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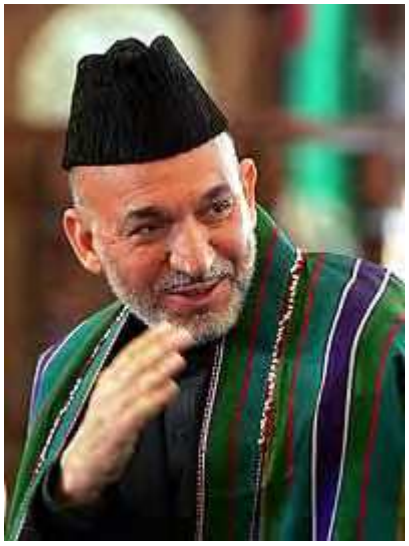
Afghanistan

No longer interim

Dec 9th 2004
From The Economist print edition

For the first time ever, Afghanistan has a democratically elected ruler

AP



Now to choose a cabinet

IT WAS testimony to the strides that Afghanistan has made since America vanquished the Taliban three years ago. On December 7th, Hamid Karzai was inaugurated as president, a job he has been doing on an interim basis since shortly after the war ended, and one to which he was overwhelmingly elected in October. The ceremony, at the former royal palace, was attended by no lesser personages than America's vice-president, Dick Cheney, and defence secretary, Donald Rumsfeld. Both were no doubt delighted to be able to celebrate a success in the war against terror. All the same, neither thought it wise to stay the night. The old regime and the al-Qaeda terrorists it harboured might be down, but they are still capable of killing.

Mr Karzai has quite a bit going for him: an enormous mandate, international goodwill, reasonably generous financial assistance and a growing recognition that it is in the western world's interest to help him defeat the drug barons if this year's bumper opium crop is not to be followed by ever bigger ones. But he also faces immense difficulties. The remnants of the Taliban still make the south and east of Afghanistan too hazardous for any form of foreign aid work: and the lure of opium money, coupled with strong traditions of local self-determination, limit Mr Karzai's authority outside Kabul. During the election campaign, he managed to hold only one rally outside the capital. Warlordism is not just a problem for the government's reputation and tax-base. It also produces a culture of petty extortion and corruption that is inimical to development.

In the past, Mr Karzai had little hope of doing anything about this. The warlords, many of whom built their power during their struggles against the Soviet invaders in the 1980s, were a fact of life. Worse, he owed his position to the Americans' allies, the Northern Alliance, who expected to be rewarded with plum posts in government. Unfortunately, the alliance included some of the most notorious of the warlords.

Gradually, however, Mr Karzai has started to squeeze them out of power—most notably, by firing Ismail Khan as governor of Herat in the west, and by dropping Mohammed Fahim, a stalwart of the Northern Alliance, from his election ticket. Now, having secured 55% of the vote in an 18-horse race, the president has a real opportunity to consolidate his position. But does he have the nerve for it?

One sign will come when the president names his cabinet. Will there still be a role for men such as Mr Fahim—or will Mr Karzai feel brave enough to risk dropping them? The support of America, if he does take the hard road, will be crucial. Much of the credit for the smoothness of the election belongs to America's ambassador to Afghanistan, Zalmay Khalilzad, who forcefully persuaded the losers not to dispute the result. The Americans will have to apply similar tactics to mollify anyone who is left out of the cabinet.

“We have now left a hard and dark past behind us,” Mr Karzai said on Tuesday. That is surely true. But it will be a while yet before the likes of Mr Cheney will be spending the night in Kabul.

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Floods in the Philippines

The usual suspects

Dec 9th 2004 | MANILA
From The Economist print edition

The government has few options bar rhetoric

AS THE toll of dead and missing from landslides and flash floods in the north-east of the country passed 1,500 last weekend, President Gloria Arroyo led a chorus of blame directed at illegal logging. It was a familiar refrain, heard almost every year since 1991, when floods killed at least 5,000 in the eastern district of Ormoc, and since when little has been done to counter deforestation.

Hundreds of logs that appeared to have been felled by saws lay amid the wreckage of the most ravaged communities, in the provinces of Quezon and Aurora, suggesting that deforestation did, indeed, contribute to the destruction brought about by a not untypical series of tropical storms. However, this is still an assumption. Given the human suffering, it is politically more palatable for Mrs Arroyo to blame businessmen engaged in illegal logging, rather than government officials for taking bribes to allow them to do it, or her own reluctance to tackle population growth. A fast-growing population means there are more poor slash-and-burn farmers, and more people living in marginal areas liable to flooding or landslides.

President Arroyo reacted by ordering the suspension of all logging, legal or illegal, although subsequently exceptions began to emerge. She compared illegal loggers to terrorists, and put Victor Corpus, a former military-intelligence chief and one-time communist guerrilla, in charge of a drive to stamp it out. Mrs Arroyo pressed Congress to pass a law putting an end to all logging. The Philippines already has laws to prevent the indiscriminate cutting of timber, but they are not properly enforced.

Besides, action against logging is probably too late. It is thought that more than half the Philippines' land area of 300,000 square kilometres (116,000 square miles) was forest a century ago. Now only about 70,000 sq km remain. If the thousands who have perished since the Ormoc disaster were the victims of deforestation, it is likely that the floods and landslides that killed them were the result of damage done to hillsides and river beds years beforehand.

The best solution is to plant trees on a heroic scale. But the billions of dollars required to do it are not available to a government in the throes of a fiscal crisis from which it does not expect to escape until 2010. The sad truth is that years of floods and landslides lie ahead.

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Saudi Arabia

Terror in Jeddah

Dec 9th 2004 | CAIRO
From The Economist print edition

AFP

Despite this week's attack on an American consulate, the Saudi state may be beating the terrorists. But it has turned its back on liberal reform

Get article background

LAST month, the Saudi government boasted that it had all but defeated the local Islamist terrorists. This week, al-Qaeda stormed the American consulate in Jeddah, Saudi Arabia's second city, killing five people. Is Osama bin Laden gaining the upper hand in his homeland?

No. Since May 2003, when a series of bombings in Riyadh made plain the seriousness of the jihadist threat, the Saudi state has fought back. The past six months have been particularly hard on the militants, who had failed to score any “raids”, as they call them, since they killed 22 people in a rampage on May 29th. Of the 26 most-wanted men named last year, only seven remain at large. Dozens of others have also been taken out of action.

Nor was the Jeddah attack, for all its boldness, very impressive. Four of the five assailants died, and none penetrated the hardened chancellery within the consular compound. Few Saudis believe such violence will achieve its proclaimed goal of ridding Arabia of “polytheists”.

Dogged police work has whittled down the jihadists' potency, while stricter controls on Islamic charities have reduced the scope of terrorist funding. At the same time, some of the more fanatical interpretations of Muslim scripture have been expunged from Saudi schoolbooks. Perhaps more significantly, the Saudi state has enlisted some persuasive voices to denounce the terrorists. Several once-popular militant clerics have publicly recanted. Earlier this week, Saudi television aired emotional interviews with the parents of several jihadists, who said their sons had been the victims of a deviant death cult.

Meanwhile, the Saudi government has been buoyed by the price of oil, which remains (for it) deliciously high. Export revenues are set to reach $110 billion this year, up from $61 billion in 2002. The extra cash helps keep the police happy: recent bonuses equalled two months' salary. It also makes ordinary Saudis more confident. Saudi share prices have been at a record high. Not long ago, red ink in the state budget, rising unemployment and declining social services were prompting talk of an imminent crisis. No more.

Yet though pocketbooks are plump, unease lingers. Many Saudi youths are bored, alienated and angry with America; this combination continues to provide a ready pool of recruits for jihadism. Some of these zealots may meet their doom safely across the border in Iraq. But others may prefer to tilt at “crusader” targets closer at hand. The Saudi state will probably continue to pick these off in small numbers, but senior princes are reluctant to permit the kind of pluralist reforms that might allow them to express their

frustrations in less extreme ways.

When the government was short of cash, the royals appeared to consider liberal reforms, which many Saudi journalists and businesspeople were demanding. But now that their money worries have lifted, and their worries about security have grown more acute, they have gone back to their old reactionary habits.

In March, a group of reformists were jailed for calling for a constitutional monarchy. Three are still awaiting trial. In September, the government issued an edict banning all state employees, which means most working Saudis, including academics, from publicly questioning state policy. In October it announced that long-promised elections for 178 town councils, now due in February, would be for only half of their seats, with women entirely excluded. Few people have bothered to register to vote, prompting one columnist to lament that Saudis show less interest in polls than in the stock index.

All this has widened the gap between the aspirations of many Saudis and the realities they must live with. This would not be so bad, except that Saudi society is already deeply split between fundamentalist and secularising trends. This is a country that recently licensed its first female pilot, but which bans women from driving; which boasts the heaviest usage of mobile phones in the world, but has outlawed models that can take pictures. America's invasion of Iraq has further aggravated such divisions. To many traditionalist Saudis, anyone who expresses the least yearning for American-style freedoms is probably an apostate.

The ruling al-Saud family may have hounded violent radicals mercilessly, but it still coddles the conservatives who run the country's schools, courts and censorship offices. While these “official” clerics blast both extremism and America's perceived war against Islam, they also proclaim that obedience to the ailing king is a religious duty. In other words, they issue a contradictory message that alienates would-be modernisers, religious and secular alike.

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Iraq

Delay the poll? Absolutely not

Dec 9th 2004 | BAGHDAD
From The Economist print edition

The Shias and Kurds—but few Sunni Arabs—want to stick to the timetable

Reuters

The happy task of policing Iraq

JUST about everyone in Iraq says they are ready for a general election on January 30th—bar the insurgents and the Sunni community from which they gain succour. The Kurds' two dominant parties say they now have a single list of candidates. And people close to Iraq's most influential clergyman, Grand Ayatollah Ali al-Sistani, say they have drawn up a United Iraqi Alliance encompassing the main Shia parties, plus the followers of Muqtada al-Sadr, until recently a rebellious Shia firebrand.

The Sunnis will not, however, be without representation. Sunni-dominated parties include the long-established Iraqi Islamic Party, led by former exiles, along with several new outfits, such as President Ghazi al-Yawer's Iraqiyun. Other alliances, to make themselves look less sectarian, are also offering slots to leading Sunnis. But none of the Sunni parties has the organisational clout of the main Kurdish or Shia ones. And the most influential group of Sunni clergy, the Muslim Scholars' Board, has called for the election to be boycotted.

Even worse, for the Sunni Arab parties, is the insurgency's enduring strength in the areas where they hoped to win most votes. Graffiti on the walls, decrying the elections as an American sham, promise death to anyone who casts a ballot, and many officials charged with distributing voter-registration cards have quietly returned or dumped them lest they be killed.

That is why the Iraqi Islamic Party and other Sunni Arab groups have begged for the poll to be delayed by six months, in the hope that security might improve. But Mr Sistani and the Shias, sensing power (their community accounts for some 60% of Iraqis), say the January 30th date is non-negotiable. Iraq's interim prime minister, Iyad Allawi, its election commission and American officials all say the interim constitution does not provide for a delay, however much they want Sunni Arabs to feel they have a stake in the system. No matter how many polling stations are attacked or ballot boxes burnt, the election is likely to take place on time, though Mr Allawi now says the poll could be spread over several weeks. The winners will probably form the next government.

The Americans are hoping that the operation, involving some 9,000-10,000 polling stations, will simply be too big for the rebels to defeat. They also say that the rebels' loss of their haven in Fallujah, where bombs were assembled and foreign volunteers and others trained to deliver them, has reduced the number of big attacks. Car bombs, they say, fell in number from 44 four weeks ago to 12 in the last week of November. American generals also hope to keep the rebels off-balance, with persistent sweeps like the one last month in the countryside south of Baghdad. And they are speeding up the deployment of Iraqi police commando battalions made up largely of Saddam-era veterans with a sprinkling of Kurdish guerrillas, one of the few parts of the government's forces that has fought well.

On the political front, Mr Allawi has met Sunni Arab tribal leaders from Iraq's most violent areas, to urge them to press their followers to vote, lest they have no voice in the next government. But if Sunni Arabs are scarce in the next parliament, the Kurdish and Shia leaders expected to run the government may not be that sorry. They will simply blame the Sunni insurgents for disfranchising their co-religionists. The only way—they will argue—to win fair representation in the new Iraq is to co-operate with the government against the rebels, not to shelter them.

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America and Middle East democracy

They'll do it their way

Dec 9th 2004 | CAIRO
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Infidels cannot make the Arab world democratic, but perhaps Arabs can

THE American government contends that the lack of political freedom in the Middle East is radicalising its youth, and so spawning terrorism. Arab states retort that it is the threat of militant Islamism—which they say is fuelled by western policy—that prompts them to limit such freedoms. Ordinary Arabs are torn between their hostility to outside pressure, their desire for reform and their fear of what reform might entail.

The argument grew heated a year ago, when President George Bush announced a “forward strategy for freedom” for the region. Soon after, details were leaked of an American plan to corral western donors behind the promotion of political liberalisation from Pakistan to Morocco. The initiative raised hackles, not only because it seemed intrusive, but also because the invasion of Iraq created the impression that America intended to impose democracy by force, or at least by the threat of it.

In the event, America's bite has proved milder than its bark. A much heralded shift of American aid money away from supporting governments and towards backing “popular empowerment” has turned out to be small in scale and limited in impact. A key component of this, called the Middle East Partnership Initiative, has disbursed little more than $100m over two years, in what one Washington think-tank describes as “a scattershot approach that splits an already small funding pie into minuscule fragments”.

American diplomacy did secure backing from other rich countries for the general idea of promoting reform, along with promises to co-ordinate strategies, at a summit of G8 rich countries in June. On December 11th, at a follow-up meeting in Morocco, G8 ministers and their regional counterparts are expected to endorse a broad agenda. Yet the few details available suggest this agenda will be skewed towards small-scale economic projects rather than political reform.

This shift of emphasis amounts to a recognition of reality. Iraq is hardly seen as a model, and the superpower's unpopularity in the region has crippled its persuasive powers. At the same time, America has noticed that for all their flaws, Arab regimes have mostly proved reliable allies in combating terrorism, and that they are responding, albeit slowly, to internal pressure for reform. Economic power is shifting away from states and into private hands. Milder-mannered forms of Islamism are evolving, aided by slightly freer media. The younger generation of Arabs may be less fettered than their elders.

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Southern Sudan

The refugees prepare to return home

Dec 9th 2004 | JUBA
From The Economist print edition

Western Sudan may be in flames, but the south is poised for peace

AP

Juba—a nice spot for a new Nilotic capital

WHILE war rages unchecked in western Sudan, southerners are preparing for peace. The outside world's efforts to end the killing in the Darfur region “are getting nowhere”, complained John Danforth, America's ambassador to the UN, this week. But Sudan's other civil war, between the Muslim Arab-dominated north and the black, non-Muslim south, is nearly over. Both parties—the northern government and the southern rebels—have promised to sign a peace deal by the end of this month. And unlike the frequent truces relating to Darfur, which “mean nothing at all”, according to Mr Danforth, this one is expected to stick.

The most striking sign of optimism is that hundreds of thousands of refugees from the south are preparing to go home. Indeed, UN officials claim that a great migration has already begun.

Under the proposed peace deal, John Garang, the leader of the main southern rebel movement, the Sudan People's Liberation Army (SPLA), will become vice-president of a federal Sudan and his people will, in effect, take over the south. They will have an equal share of Sudan's oil revenues, but at present they have practically no one with experience of governing. So they are frantically looking for administrators, teachers, electricians and more or less any southerner with skills.

Along with the oil money, there will also be aid money flowing southwards. On November 30th, the UN launched an appeal for $1.5 billion for Sudan for 2005. Some $600m of that will be for Darfur, but much of the rest will go to the south. A UN peacekeeping force of perhaps 7,000 will begin to deploy, and various aid agencies will set up shop and start hiring clerks, interpreters, drivers and accountants.

Of the more than 4m people displaced during the north-south war since 1983, the UN predicts that up to 1.2m, mainly southerners, will go home next year. By one estimate, some 400,000 southerners have already returned. Even if that is an exaggeration, there is no mistaking the mood of nervous hopefulness. Southerners who may not have been home for two decades are gingerly walking or cycling back to see if there is still land for them in their old villages. Worried about a scramble, some families are sending one member ahead to “book” space for the rest.

Juba, the town of 200,000 that is likely to be the new capital of southern Sudan, still feels like a large, dilapidated village. The town centre is full of mud huts and goats. Many townspeople wash in the Nile and walk everywhere for lack of buses. But Juba is bracing for change.

The town was almost completely cut off during the war, but commercial flights have now started to Khartoum, Sudan's capital. A mobile-phone network is up and running, and enterprising vendors are pedalling more than 100km (62 miles) up from Uganda with boxes of beer on the back of their bicycles. Tarmac roads are planned, and one between Juba and the Kenyan border is already being built. With peace, other main roads will be cleared of land-mines. When trucks can get through, the staggeringly high prices of goods in Juba's market are sure to tumble.

There are plans to open a local newspaper, and for another, the *Khartoum Monitor*, currently run by a southerner in the Sudanese capital, to move to Juba. Alfred Taban, the *Monitor*'s editor, says he is so

excited at the prospect of going home that he has already been to Juba to find land to build a house. Once the peace deal is signed, he predicts, a flood of educated southerners, now in Khartoum or abroad, will surge home.

At the office of the UN's World Food Programme (WFP) in Juba, the boss, Abebe Hankore, has to shout above the noise of builders. The WFP has prepared kits of food and tools for half a million expected returnees, he says, and he is expanding his office to accommodate new staff. If the peace deal is signed, the UN's mission to southern Sudan, which has long operated out of Kenya, will move to Juba and Rumbek, the southern town where the SPLA has its headquarters.

Various embassies in Khartoum have already been scouting Juba with a view to opening consulates. Officials from the UN's peacekeeping department have also been in town. They asked Mr Hankore if, maybe, he could find space for some of them in his office. He says he replied: “You must be joking; my people are already going to be working out of pigeon-holes.”

As people feel safe enough to move about more, Juba's main hospital, which is kept stocked with drugs and running only thanks to the Red Cross, is getting crowded. Medical staff fear that once traffic starts to flow freely in and out of the town, their workload will triple. Similar worries grip the south's sparse schools, clinics and every other kind of social service. Reconstruction, after a war that paused only for one decade in the past five, will be a colossal task.

And what then? Six and a half years after the peace deal, southerners will vote on whether they want independence. Most people in Juba say they will vote yes; almost everyone has vivid memories of being terrorised by “the Arabs”.

One retired civil servant in Juba recalls being arrested on suspicion of talking to the BBC and kept in a container for 43 days. He was lowered into a grave, subjected to a mock execution and then hung upside down from a tree and beaten. He says he is delighted that he is now free to talk to foreigners without fear of “disappearing”. But neither he nor many of his fellow southerners want to remain part of the country that subjected them to so many horrors for so long.

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Russia's president

Vladimir III?

Dec 9th 2004 | MOSCOW
From The Economist print edition

Ukraine has made Vladimir Putin look foolish. But at home, he remains unchallenged—and Russia and the world may be stuck with him

ON THE face of it, he seems humiliatingly weak. Vladimir Putin's intervention in Ukraine's election was one of his biggest mistakes as Russia's president. If Victor Yushchenko wins Ukraine's re-vote on December 26th, as seems likely (see article), the waning of Russia's sway in its erstwhile "sphere of influence" will be embarrassingly obvious. At home, the seemingly interminable Yukos saga may be reaching its terminus. Yet the Kremlin's campaign against what was Russia's biggest oil company has been so mishandled that, even as it has dramatised Mr Putin's authority, it has also made him look amateurish and indecisive.

Appearances can be misleading, however. Ukraine's "orange revolution" may yet inspire independent forces elsewhere in the former Soviet Union. In Abkhazia, a breakaway micro-state in Georgia that is heavily dependent on Moscow, October's "presidential" vote is to be re-run, after Mr Putin's man apparently lost. But Russian liberals hoping for a revolution of their own face a long wait. Mr Putin's shadow post-Soviet empire may look more tenebrous than ever. Yet in Russia itself, the emperor still has clothes.

Russian politics is an odd combination of volatility—Chechnya, terrorism, Yukos—and inertia. Partly because of the Kremlin's control over Russian television, Mr Putin remains wildly popular. His approval ratings hover around 70%: down from their peak, but still impressively stellar. Indeed, so unassailable is his position that the question of how he might remain in power when his second presidential term expires in 2008 has developed into a lively debate among Moscow's commentariat.

Getting it and keeping it

The argument that Mr Putin will stay on is simple. Having accumulated power so determinedly, he and his entourage are unlikely to give it away. Centralisation has been Mr Putin's default response to any challenges. On past form, his humiliation in Ukraine may lead to a further tightening of the screws. Already, the media have been domesticated. A law to allow the president to appoint regional governors, announced after the Beslan school atrocity, has just gone through Russia's parliament. Another post-Beslan reform will squeeze out the last vestiges of independence in the Duma, the lower house.

Russia's notorious “oligarchs” have also been tamed. Boris Berezovsky and Vladimir Gusinsky, two of the most unco-operative, are in exile. Mikhail Khodorkovsky, on trial for fraud and tax evasion, has been in prison since his arrest in October 2003. And Yukos, the oil company Mr Khodorkovsky once ran, looks set to be eviscerated when most of Yuganskneftegaz, its oil-production subsidiary, is sold on December 19th. What remains of Yukos may also be seized, to requite alleged tax debts of some $25 billion. The near-certain purchaser of Yugansk is Gazprom, the state-run gas monopoly. Swallowing Yugansk will turn Gazprom into an energy behemoth that serves Russia's foreign-policy interests even more powerfully.

Reviving the state's control over the energy industry may have been a motive for attacking Yukos in the first place. Mr Khodorkovsky's open meddling in politics was certainly another. Other, more acquisitive reasons may have sustained the campaign: nobody outside the Kremlin really knows. This opacity means that nobody can be sure if the Yugansk sale will be the beginning of the end of Mr Putin's confrontation with the oligarchs, or only the end of the beginning.

Sometimes the president implies that, if they behave, big businessmen can keep what they got in the privatisations of the 1990s. But at other times he is more bellicose. Oligarchs still at liberty in Russia are lying low. One unwelcome development came this week when VimpelCom, a telecoms firm part-owned by Mikhail Fridman's Alfa Group, was hit by a claim for back tax reminiscent of those previously sent to Yukos. The financial markets tumbled on the news.

The easiest way for Mr Putin to hang on to all his power would be to emulate Alexander Lukashenka, president of Belarus, and change Russia's constitution—either the clause limiting a president to two consecutive terms, or the one setting their length at four years. Mr Putin has repeatedly said that he will leave the constitution alone. But he could argue that terrorism, Chechnya and the supplications of his countrymen had changed his mind. Since a change would require approval by two-thirds of regional legislatures, conspiracy theorists see the reforms to regional government as a preparation.

Another possibility is that, true to his habit of observing the letter of the law while violating its spirit, Mr Putin might prefer to redistribute power from the presidency to parliament and United Russia, his pet party—a reform rather like the one President Leonid Kuchma is pushing through in Ukraine. Mr Putin could then avoid the messy inconvenience of direct elections. But this looks less likely. The Russian public, says Andrei Ryabov of the Carnegie Centre in Moscow, might find it hard to understand “two suns in one sky”—ie, Mr Putin and whichever stooge were installed as a weakened president. Russian leaders are used to behaving like tsars, as well as being regarded like them: taking big decisions but leaving much of the work, and the attendant unpopularity, to ministers. The government's approval rating is around half that of Mr Putin.

Or the president might choose what, pre-Ukraine, was the favoured means of succession across the former Soviet Union: the anointment of a trusted successor. On past form, that person could be toiling in an obscure government post. That would leave open the possibility of Mr Putin, a young and fit man, returning for another eight years in 2012: the constitution limits the consecutive terms a president may serve, not the total number.

Mr Putin is emerging more and more as a tactician, not a strategist. Economic reform, for example, has stalled since high oil prices offered an easier path to growth. His commitment to democracy now looks to be a tactic too. He may not yet have decided what to do in 2008. Boris Nemtsov, co-founder of a committee set up to make sure he leaves on schedule, says that, if he does want to stick around, international obloquy would give him greater pause than domestic opinion. European and American leaders would react badly to a rejigging of the government, and with horror to a change in the constitution.

In private, though, they might be relieved. A genuine transfer of the president's powers to a new man would be as perilous as it looks unlikely. Any challenge to Putinism would not come from the liberals, who were almost banished from the Duma at last year's election. As Vyacheslav Nikonov, an analyst with Kremlin connections, points out, without much exaggeration, “Putin is more liberal than 95% of Russians”. Nor would it come from the waning Communist Party. The coming men in Russian politics are less democratic, more nationalistic and more worrying even than Mr Putin—a point he may want to emphasise to his western critics.

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Ukraine

The end-game

Dec 9th 2004 | MOSCOW
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Peace breaks out in Ukraine, at least for the time being

AP

Yes to another vote on December 26th

AFTER all the allegations of murder, corruption and illicit arms sales levelled against Leonid Kuchma during his ten-year presidency of Ukraine, his prospects of being remembered as a statesman are dim. But they brightened a little on December 8th, when Mr Kuchma and the Rada, Ukraine's parliament, agreed a package of laws that have brought some calm to their country's rancorous presidential election—and also to the streets of Kiev, which has been convulsed by demonstrations ever since Victor Yanukovich, Mr Kuchma's preferred successor, was implausibly said to have beaten Victor Yushchenko in the second round of the presidential election on November 21st.

In a decision with happy implications for the independence of Ukraine's judiciary, as well as for a peaceful resolution of the current crisis, the country's supreme court on December 3rd ordered the vote to be re-run. Mr Kuchma and Vladimir Putin, Russia's president, had both opposed that idea. The poll is scheduled for December 26th. But, until Mr Kuchma's deal was struck with Mr Yushchenko and the Rada, it seemed possible that the third round could prove to be just as rigged and controversial as the second.

In the wrangling after the court's decision, Mr Kuchma pushed, as he has long done, for a constitutional reform to transfer many of the powers that he has enjoyed to parliament, where he and his oligarch allies remain influential. Mr Yushchenko wanted new rules to prevent electoral abuses. After further mediation by European bigwigs, both men got most of what they wanted. The president's powers will be reduced, though not immediately; Mr Kuchma may also have won private reassurances about his own future. The bogus use of mobile and home voting will be restricted. And some discredited members of the central election commission, which had declared Mr Yanukovich the winner, have been ejected.

The one big demand not to be met is for Mr Yanukovich to be sacked as prime minister (although the prosecutor-general's head rolled as a consolation). The Yushchenko camp alleges that he exploited this position to warp the most recent round of voting. Mr Yanukovich duly criticised the court's ruling. But, despite being advised by Mr Kuchma to withdraw from the race (and thus to discredit the whole procedure), he also insisted that he would stand in the December 26th re-run. He has taken leave from his post to campaign, and is trying, not very convincingly, to distance himself from Mr Kuchma.

Compromises in the constitutional reform should pacify some of the more radical elements within the Yushchenko camp. Some supporters—notably the youth movement Pora (“It's time”), which has been in the vanguard of the pro-Yushchenko “orange revolution”—disliked any notion of negotiating with Mr Kuchma. Yulia Timoshenko, a volatile but important ally, had talked darkly about Mr Kuchma's fate if he

did not co-operate. It now looks as if her hard-cop/soft-cop act with the more diplomatic Mr Yushchenko has worked. But another rift opened by the stand-off in Ukraine, between Russia and the West, continues to widen.

Geopolitics may not have been uppermost in the minds of Ukrainian voters. Many want to live as Europeans do, by which they mean well-off and corruption-free, but are less interested in international links. Yet the European Union and Russia are certainly interested in them. Mr Putin, who backed Mr Yanukovich, this week decried Mr Yushchenko's tactics. Sergei Lavrov, Russia's foreign minister, criticised what the Russians said was the political bias of western election monitors. Colin Powell, America's secretary of state, vigorously denied Russian claims that the West was meddling.

International organisations are scrambling to assemble new monitoring teams for December 26th. As his friends desert him, and failing extreme measures, Mr Yanukovich's chances look slim. But in Ukraine almost anything is possible.

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Turkey and the European Union

The unwelcome guests

Dec 9th 2004 | AMSTERDAM, BERLIN, BRUSSELS AND PARIS
From The Economist print edition

Despite doubts and grumbles around Europe, next week's EU summit will say yes to the opening of membership talks with Turkey

YOU might be forgiven for assuming that, when European Union leaders meet in Brussels next week, they will have little to say on the main item on their agenda: Turkey's bid to join the EU. The European Commission has recommended the opening of membership talks next year, and most EU leaders are in favour. Yet discussion could still be acrimonious.

The first issue will be when to start the talks. The Turks want a date early in 2005. What they will probably get is a promise of a start some time in the second half of 2005. The reason is that the French referendum on the EU constitution could be in May, and the government is desperate to avoid Turkey clouding the debate. A second argument will be whether to accede to those who want to state explicitly that talks may not end in membership, but instead in a “privileged partnership”. The betting is that no such reference will appear in the summit's conclusions.

Turko-sceptics may be thrown other bones, including a “trigger mechanism” providing that negotiations can be suspended if Turkish human-rights reforms go into reverse. There will be debate too about whether to suggest that membership might include permanent exceptions from normal EU laws, especially on free movement of people. Yet the subject of permanent derogations is also unlikely to feature in the conclusions.

Lurking behind these questions is the fear that Cyprus, a new EU member, could sabotage the whole deal. The official position of the (Greek-Cypriot) government is that unless Turkey recognises it, it might veto the opening of talks. But the Cypriot government, already in bad odour because it encouraged the Greek-Cypriot rejection of the UN's unification plan in April, will come under huge pressure not to cast its veto now.

Other new members are largely favourable to Turkey. Poland has misgivings, but is now keener as a way of promoting the admissibility of Ukraine. Poles also remember that throughout the 19th century the Ottoman empire refused to recognise their country's elimination. At diplomatic functions, the sultan would repeatedly query, “Where is the Polish ambassador?”

Of the rest, Britain, Scandinavia, Italy and the Iberian duo are essentially on Turkey's side. The main nervousness is to be found in France, Germany, Austria and the Netherlands. In France, President Jacques Chirac's enthusiasm for Turkish entry is out of tune with his people and his party. He has long argued that Turkey has “a European vocation”, and yet polls show some 75% of the French against Turkish entry. France's ruling UMP party is against, as is Nicolas Sarkozy, its freshly elected boss.

The main French objection is that Turkey is big, poor and, above all, Muslim. The French fear not only Turkish workers, but also a louder voice for Islam. France already has Europe's biggest Muslim population, and it is finding it hard to reconcile its model of integration, which relies on a strict separation of religion and state, with demands by French Muslims for religious expression within public institutions. If France has trouble accommodating a big Muslim population, some ask, how can Europe manage a whole country?

The other French objection concerns the changing nature of Europe. The creation of ever-closer union was once a clear Franco-German project. But the EU is becoming a looser entity, with limited political ambition, where English prevails over French. Some see Turkey's admission as a final confirmation of this trend. Mr Chirac has given some ground, promising a referendum on Turkish entry in 10-15 years' time. In his recent visit to Germany, he also hinted at a “third way”: although affirming that “Germany and

France share the same objective: to bring Turkey into the European Union", he also spoke of creating "a sufficiently strong link" with Turkey, short of full membership, if the talks failed.

In Germany, Turkish entry into the EU is even more sensitive than elsewhere. Yet apart from the occasional populist outburst, the debate has so far been surprisingly rational—and almost as many Germans are for full Turkish membership as are against it. One might have expected Chancellor Gerhard Schröder and, even more so, his foreign minister, Joschka Fischer, to be hesitant. But the threat of international terrorism has changed their tune. "If we succeed in integrating an Islamic country, this would tremendously increase our security," says Mr Schröder, adding that it would be inconceivable for the EU to shut the door after having made promises to Turkey for more than 40 years.

Yet the opposition Christian Democrats (CDU) argue that, even if Turkey is ready for full membership, the EU is not, either culturally or politically. "A Europe with Turkey won't be a Europe of deep integration," Angela Merkel, the CDU leader, told her party's annual congress this week. Ms Merkel is the strongest exponent of the notion of a "privileged partnership", and she is still hoping to get a reference to it inserted into the summit's conclusions, by pushing a fellow-conservative, Wolfgang Schüssel, Austria's chancellor, to back it. His government supports the opening of negotiations with Turkey, but much of domestic opinion in Austria is hostile.

It is not lost on Germany's politicians that Germans with Turkish roots are a growing constituency, and one in which the governing Social Democrats are said to have a two-thirds majority. Even Ms Merkel is not insensitive: were she to become chancellor in 2006, she would not jump off the train after the negotiations have begun. But she cannot always resist populist temptations: for a few days in October, she toyed with the idea of organising a petition against full EU membership for Turkey. And the debate in Germany on Turkey's eventual membership could still turn ugly in future. Indeed, it is likely to flare up every time a decision on Turkey has to be taken in Brussels, particularly if it coincides with one of the endless number of electoral campaigns in Germany.

Presiding over next week's summit will be the Dutch prime minister, Jan Peter Balkenende. His task will be the more delicate as opinion in his country, never too keen on Turkish entry, has turned strongly against, largely as a result of the turmoil over Islam that followed the murder of Theo Van Gogh last month. Mr Balkenende's party, the Christian Democrats, is divided; so is its Liberal (VVD) coalition partner. The outgoing Dutch European commissioner and former VVD leader, Frits Bolkestein, once said that Turkish accession might mean that the repulsion of Ottoman forces from the gates of Vienna in 1683 had been in vain. Yet the Dutch EU presidency is still likely to end by sponsoring the opening of membership talks with Turkey, for all that.

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Baltic politics

All change

Dec 9th 2004 | RIGA
From The Economist print edition

The benefits of instability

Get article background

THIS week Lithuania was putting the finishing touches to its 12th government in 14 years of independence—or the 13th, if you count a three-day caretaker administration in 1991. Neighbouring Latvia has its ninth prime minister in 11 years, Aigars Kalvitis, appointed last week by President Vaira Vike-Freiberga. The third Baltic state, Estonia, is calmer: its seventh post-Soviet prime minister, Juhan Parts, was elected in March 2003 and could even stay for a full four-year parliamentary term, a first for the Baltics since the collapse of communism.

What a mess, you might say. But the striking thing is how well it has been contained. Very little spills over into policymaking. This year all three Baltic countries joined NATO and the European Union, winning high marks for being ready. Estonia led post-communist Europe in its economic reforms. For five years the Baltics have chalked up higher growth rates than other EU hopefuls such as Poland and Hungary.

How so? One answer is that the Baltic countries had the strongest incentive to reform when communism collapsed, because they were in the worst shape. Unlike Poland or Hungary, they were inside the Soviet Union, subject to the full force of collectivisation and Stalinist central planning. Their economies had to be rebuilt from scratch. Second, the goal of EU accession dictated a ready-made programme of policies for all governments to follow. The Baltics did so the most doggedly, for fear that failure might push them back into Russia's orbit.

But comparison with Romania, the least successful of central Europe's reformers, now suggests a third reason. There, a botched election last week and doubts over the country's readiness to join the EU in 2007 are letting light into a system of government enmeshed in webs of clientelism and corruption extending from the ruling socialist party, whose bosses have held or shared power for ten of the past 14 years.

Corruption taints Baltic politics too, especially in Latvia and Lithuania. But because Baltic governments are weak and fast-changing, they are also limited in their ability to advance their financial backers' interests. In short, they have had less scope to do harm than to do good. Stability may be a virtue, but competition can be even better.

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French political families

Celebrity politics

Dec 9th 2004 | PARIS
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A new cult from America

"A MOTHER who fails with her child, who cannot restore a sick child to health, always feels guilty," admitted the mother of an anorexic and one-time suicidal daughter to the chat-show host. Nothing unusual, given the confessional nature of French television these days. Except that the mother was Bernadette Chirac, the president's wife. And this is France, where the private lives of public figures are usually kept strictly off the airwaves. What is going on?

In unburdening herself of the story of Laurence, kept private for 30 years, Mrs Chirac was not alone in exposing her family. Nicolas Sarkozy, the new head of the ruling UMP party, rounded off a film celebrating his election with "*bonne chance, mon papa!*" from his seven-year-old son. Hervé Gaymard, the new finance minister, poses often with his eight children. For a country whose former president, François Mitterrand, kept secret until his final years a daughter whom he had with his mistress, this is revolutionary stuff.

Mrs Chirac's case is special: she was talking about her new medical centre for teenagers. And hers was also an admission of family dysfunction, rather than the promotion of domestic perfection. Even so, the intimate political marketing of families marks a new trend in French politics: in a word, Americanisation.

It is not just that France's system has become more presidential since the term of a president was cut from seven years to five. It is also a matter of style. Mr Sarkozy's stage show, complete with giant images of him surrounded by adoring crowds, echoed American conventions. When he appeared on a chat-show, he naturally brought his wife, Cécilia—who, bizarrely, walked off the set hand-in-hand with Robbie Williams, a British pop star. Even French politicians, it seems, are ready to risk over-exposure.

Perhaps they are simply catching up with French taste. Celebrity magazines in France do a roaring trade. Prime-time schedules are clogged with such reality shows as "Wife Swap" or "My Nanny is a Celebrity". French politicians may be an elite breed, but even they cannot afford to be entirely out of tune with their goggle-eyed electorate.

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Charlemagne

The noose tightens

Dec 9th 2004
From The Economist print edition

As the process of ratifying the European Union constitution gets under way, the pressure on Britain increases

Get article background

WHEN Tony Blair signed the European Union's constitutional treaty at a ceremony in Rome in October, his face bore the tight-lipped smile of a man signing his own political death warrant. Mr Blair has promised that Britain will hold a referendum on the constitution, probably early in 2006. This week the British cabinet agreed that the question should be a simple yes or no one. But the polls suggest that British voters will say no. If that happens, Mr Blair, who once promised to put his country “at the heart of Europe”, might find that instead he became the prime minister who presided over a fatal rupture in Britain's relationship with the EU—and he might well have to resign.

Like many a condemned man, Mr Blair is hoping for a last-minute reprieve. If he cannot turn around British opinion, perhaps one of the other ten countries that have promised to hold a referendum might help by rejecting the constitution first? But such hopes have taken a knock now that the French Socialist Party has decided to campaign for a yes in France's referendum. This decision makes it far more likely that the French will vote in favour of the constitution when their referendum is held early next summer. Polls point to a strong French yes.

This news will have come as a bitter blow to Mr Blair. As one senior (and sardonic) German diplomat puts it, “both Britain and France secretly hope that the other country will reject the constitution, although publicly they both have to say they want the other to vote in favour.” The argument is that, for the British, a French no would mean that Britain avoided the danger of isolation in Europe, and might also kill off a document that they never really wanted in the first place. For the French, a British no would mean that Britain was pushed to the margins of the EU (or even out of the door altogether), giving France an opportunity to reassert its traditional leading role in Europe.

This game of double-bluff over the referendums is part of a battle royal between Britain and France for influence over the EU that has been running for some years. Each country has its flagship policy. For the British, it is enlargement to take in new members. Enlargement has the virtue, as Downing Street sees it, of making the EU simultaneously more liberal, more Atlanticist, more English-speaking and less open to control by a Franco-German axis. For precisely these reasons, the French have been deeply wary of enlargement. Instead their flagship policy has been to create a political union in Europe, through such measures as a single currency and, now, an EU constitution. The French hope that political deepening in Europe will serve their national interests by creating a new global power—under the benevolent leadership, naturally, of France and Germany.

Over the past couple of years, both these policies have advanced in parallel. The EU was duly enlarged to take in ten new members, mostly from central Europe, last May. Just as the British had hoped, the new 25-member EU is increasingly doing its business in English, and is more inclined to take a British line on economic and foreign policy. But even as enlargement was proceeding, so was the French-backed project to give Europe its first constitution. The convention that prepared the first draft was chaired by Valéry Giscard d'Estaing, a former French president, and the constitution embraces many ideas that are dear to the French, such as the creation of a legally binding Charter of Fundamental Rights, and a commitment to work towards a “common defence policy” for the EU.

Even so, the French did not get everything they wanted. As Laurent Fabius, a former prime minister who led the Socialist group that wanted to reject the constitution, declared, there is less “social Europe” in the document than the French would have liked. France has also had to swallow some reforms to the EU's

voting system that will dilute its power. But a decisive majority of Socialist Party members has rejected this Fabiusien gloom and backed the constitution. That puts the pressure back on to Britain—and raises the deliciously ironic prospect (from a French point of view) that Mr Blair's government might one day have to leave the enlarged EU that it has done so much to create.

To encourage the others

Mr Blair can still hope for a last-minute reprieve. The French may now be more likely to vote in favour of the constitution, but the Dutch, who vote next spring, are wobbling. The notion of further Muslim immigration is deeply unpopular in the Netherlands after recent events. But the constitution increases EU powers over immigration, as well as making it impossible for any EU member country unilaterally to withdraw from the international convention on asylum. A Dutch no might not deal the constitution as fatal a blow as a French one—but it would be a big shock, given the status of the Netherlands as one of the six founders of the EU. Denmark, Poland and the Czech Republic, all of which are planning referendums on the constitution, also have strong Eurosceptic voices at home, so any of them might yet vote no. Collectively, they would give Mr Blair helpful cover. But unfortunately for him, sentiment in all three countries seems instead to be moving in the direction of saying yes to the constitution. The prospect of British isolation as the only naysayer looms ever larger.

Yet the British could still play an enlargement card. Next week's EU summit is likely to take a big step towards the eventual admission of Turkey—a policy that is deeply unpopular in France. The French government is worried that the prospect of Turkish entry could poison their referendum campaign, even though they have promised a separate vote before Turkey is let in. This week, Michel Barnier, the French foreign minister, told Brussels-based journalists that “if there is a link between Turkey and the constitution, we will lose the referendum. It is as simple as that.” Those words may give Mr Blair hope. Not that he would dream of saying so in public, of course.

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Immigration

Out with the new

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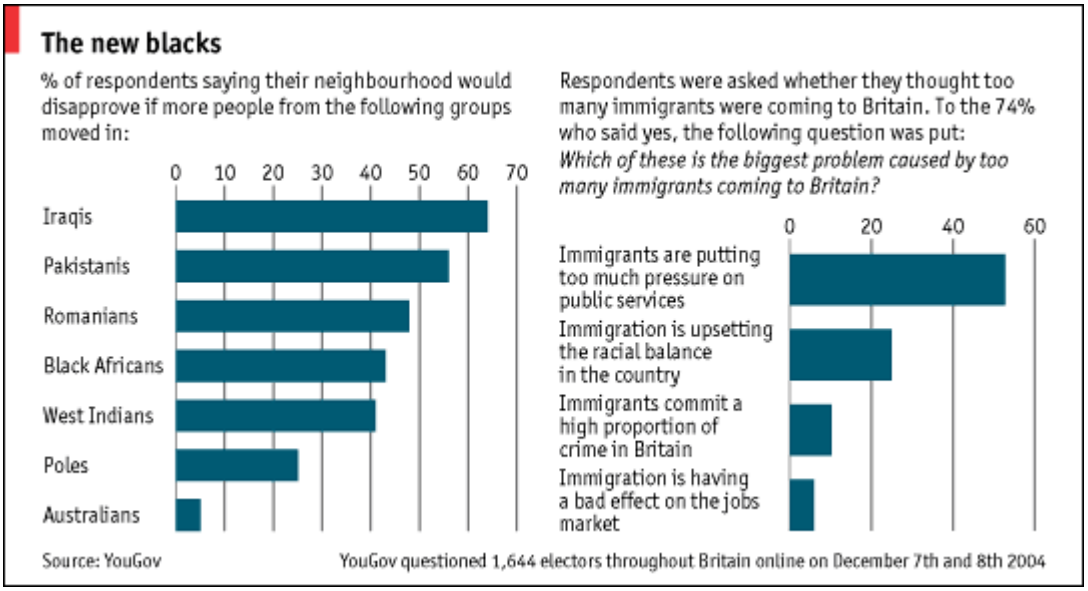
Why attitudes to immigration are hardening



THE British like to think of themselves as rather enlightened when it comes to immigration and race relations. Disputes over headscarves are left to the French. Ghettos, frank discrimination and the nasty notion that Britishness is a white characteristic endure only in coal-stained northern towns, which are stuck in the past in more ways than this. Everywhere else, a multicultural consensus reigns.

It's a view that is becoming hard to sustain. A YouGov poll for *The Economist* this week finds that 74% of people believe too many immigrants are coming into the country. Londoners, young people and the middle classes can normally be counted on to hold more liberal views, but not, it seems, when it comes to immigration. Their sentiments are virtually identical.

Most damaging for Britain's enlightened self-image, the nation has risen to the top of the European xenophobes' league. A Eurobarometer poll earlier this year found that 41% saw immigration as one of the two biggest problems faced by the nation—16 points more than in any other European country. Forget unemployment, terrorism or crime: the real threat comes from the man with the battered suitcase.

Why the hard feelings? It's a puzzle, especially given the benefits brought by new arrivals. Immigrants may depress wages in the bus-driving and vegetable-picking industries, but they are only good news for urban middle-class folk, who benefit from cheaper (and more interesting) restaurant food and plentiful nursing. Even reproduction is easier, thanks to foreign nannies. “A generation of London kids is being raised with Warsaw-accented English,” points out Trevor Phillips, chair of the Commission for Racial Equality.

The Economist's poll suggests an answer. The natives are not particularly restless about newcomers who come explicitly to work. Just 7% of those who reckon there are too many immigrants blame the number of employment permits handed out. Four-fifths believe the country needs more skilled workers, and two-fifths even think it needs more grunts.

The newcomers that grate are those who strain the delicate British sense of fair play: 85% cite either asylum seekers or illegal immigrants as the main reason the country is being overrun. They are thought to be bad news not because they take jobs or commit crimes, but because they compete unfairly for public services. Jumping the queue is always intolerable, whether it is for housing or at supermarket tills.

Hostility to those who do not come openly to work is not new. Even in 2000, before the asylum panic, just 12% believed that genuine refugees should be accepted unreservedly—the lowest number in Europe. But Britons are more blasé than other Europeans about the effect of immigration on national harmony. Of those who reckon there are too many, only a quarter worry about racial balance. “Britain has become a multicultural society; it just doesn't want any more people to come in,” says John Solomos, who follows the subject at City University in London.

What seems to have happened over the past few years is that immigration has become associated with refugees and illegal entrants rather than with migrant workers. That is not surprising, given the rise in asylum claimants that began in the late 1990s. Numbers are down, but it does not matter: perceptions have shifted.

A curious side-effect of this change is that the nation's mental image of the immigrant has taken on a different hue. “We traditionally thought of immigrants as black and brown, and for 40 years they were,” says Mr Phillips. Unlike America, where ethnic minorities and immigrants have always been viewed as two different things, Britons regarded them as one and the same. Now their attention has been drawn to paler arrivals who are often more disliked. Romanians, who are often accused of living off the state, are less popular than West Indians. Iraqis, who are not just refugees but also come from a country where our boys are dying, are more loathed than either. Pakistanis (a well-established but growing group) are disliked, too, probably because of fears of domestic terrorism and memories of riots in 2001.

The fact that immigration has less to do with race only makes it easier to dislike. Hostility used to connote racial prejudice, but no longer. That's modern Britain: multicultural, racially liberal and anti-immigrant to the core.

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Mental health and ethnicity

The enigma of arrival

Dec 9th 2004
From The Economist print edition

Why some Asian women are coping better than others

WHEN even the president of Pakistan chides a group of Britons for its hidebound attitudes to women, it becomes hard to deny a problem exists. On December 6th, President Musharraf had a go at Muslims for believing that “women should be confined to their houses and put veils on and all that”. Then he breezed off to meet some, presumably startled, Pakistani community leaders in Manchester.

South Asian family values have traditionally been admired, with good reason. Marriage is common; single parenthood is rare; the old are well integrated into family life. But drawbacks are becoming evident. This week, London's police said they would investigate 117 suspected “honour killings”, many of them involving south Asians who defied family wishes. Further evidence of misery comes from suicides, which are two and a half times more common among south Asian women under the age of 25 than among other Britons of the same age.

The unhappiness of south Asian women is partly down to the difficulty of shoehorning subcontinental habits into Britain. As Kulbir Randhawa of the Asian Family Counselling Service in Southall puts it, “The whole world is different.” Living with your mother-in-law is tolerable when you inhabit a family compound, less so when you are crammed into a terraced house. South Asians also import taboos about mental illness that make them less inclined to seek help.

But not all south Asians are equally unhappy. A 2002 study for the Department of Health found unusually high rates of depression and anxiety among Indian and Pakistani women, particularly those who were born in Britain or arrived as young children. Bangladeshis are the least troubled, although they are the poorest south Asian group. Newly-arrived Bangladeshi women are one-third as likely to be highly anxious as white women.

Different levels of frustration and cultural conflict are probably the reason. Dinesh Bhugra, a psychiatrist who is an expert on south Asian mental health, says that problems tend to arise when it comes to deciding on (and sometimes deciding between) a marriage partner and a university education. In the worst cases, the headstrong may be removed to the subcontinent and forced into marriage: the foreign office rescues 60-70 British victims every year. But even if it does not come to that, these conflicting pressures can be hard to deal with. Reconciling obligations to family and self is not a problem for the dutiful new immigrant, nor for the fully assimilated. Anybody in transition from the first group to the second will find the going rough.

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Education

Bad marks all round

Dec 9th 2004
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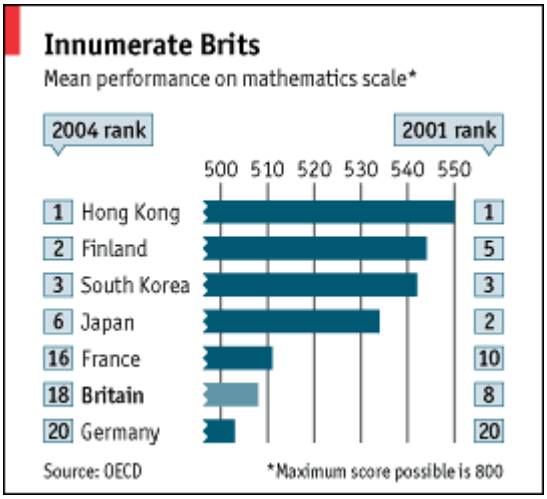
Britain has slipped down the international education league



THE results of a new international comparison of 15-year-olds' scores in maths, reading and science, sponsored by the Paris-based Organisation for Economic Co-operation and Development (OECD), are disappointing. The government's attempt to disguise them makes them embarrassing as well.

The OECD's first Programme for International Student Assessment (PISA) study published in 2001 showed Britain doing rather well: the students surveyed came eighth out of 32 countries in maths and reading, and fourth in science. The government was thrilled, and overruled OECD statisticians who said that Britain's response rate was too low for the results to be statistically robust. For the latest study, the response rate was marginally lower, but the results much worse: Britain came 11th in science and reading, and 18th in maths.

When the government learnt this, it changed its stance. Instead of lobbying hard to have Britain included in the league tables, it insisted that it be left out. The OECD was happy to agree—the final response rate among British schools was only 77%, against an OECD target of 96%.

The government brushed aside criticisms of Britain's poor performance by saying that the sample is too small. That would be fine—if results based on a broadly similar response rate in the 2001 study had not been trumpeted as a sign of triumph. And as Alan Smithers of Buckingham University points out, high-achieving schools and pupils are most likely to take part in a study of this kind—so a small sample is likely to flatter, and the real picture could be even worse.

The tests have changed, so some change in league-table positions could be expected. But Britain's poor maths performance is more than a mere statistical illusion. Again, the explanation is embarrassing for the government. The maths tests in the latest study were more extensive than in the first PISA, and included arithmetic, in which British students did particularly poorly. Other gloomy findings were that only Turkey, Luxembourg and Mexico recorded higher dissatisfaction with their teachers' qualifications and experience.

In short: Britain's educational performance, compared with the competition, has probably not deteriorated. It just wasn't very good in the first place.

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Killing burglars

Tory bunglery

Dec 9th 2004
From The Economist print edition

Why changing the law might make the Conservatives feel safer

SIR JOHN STEVENS, the head of London's police, thinks that Britain's burglary laws are too soft on criminals. A troupe of indignant newspaper columnists agree. Listeners to “Today”, an influential BBC breakfast radio show, voted it their most-wanted new law.

This week, the Tories hoped to catch the mood, tabling a bill that replaces the old idea that householders can use “reasonable force” against intruders with a new one, that all but “grossly disproportionate force” is allowed. Tony Blair, always unwilling to be outflanked by the Tories on crime, responded by saying that the law might need to be changed.

The facts suggest otherwise. Under the existing law, only two people have been imprisoned for using force against burglars within recent memory. The first, Tony Martin, shot a teenager in the back with an unregistered shotgun while the boy was climbing out of a window. The second, Barry-Lee Hastings, stabbed a man 12 times in the back, and kept stabbing even after the burglar had left the house. Neither makes a credible folk hero. Dominic Grieve, the shadow attorney-general, who drafted the bill for the Conservatives, concedes that no have-a-go heroes have been convicted.

However, Mr Grieve argues that “the law is not working properly if people are being dragged through prosecutions when they should never have been prosecuted in the first place.” He cites two cases, one from 1991 and one from 1995 (when the Conservatives were in power). In both instances, householders fired shotguns at burglars. In one case, charges were dropped. In the other, the shooter was prosecuted, but the jury found him not guilty. Anthony Branley, the solicitor who acted for Mr Hastings, points out that householders have killed burglars and not been prosecuted—all of which suggests that the current law allows the use of plenty of force.

Michael Wolkind QC, who represented Mr Martin in the Court of Appeal, says it is hard to improve on “reasonable force” as a test. “The phrase ‘grossly disproportionate’ is nonsense,” says Mr Wolkind. “It suggests that using quite disproportionate force is okay.” Victim Support, a charity, says it has not been receiving distressed calls from people who have tackled burglars and then found themselves in the dock.

The proposal says less about householders' vulnerability than about the Tories'. The latest poll shows them trailing at 33% to Labour's 37%. It was at those depths that the party ditched its hapless leader, Iain Duncan Smith, for Michael Howard, a respected ex-minister.

Mr Howard began the job with prime ministerial gravitas, but has since fallen back on tut-tutting like a pub bore. His speech backing the bill, in which he described the existing law as “typical of the topsy-turvy, politically correct world in which we live”, is just the latest example. One reason for this is that Mr Howard sometimes mistakes headlines for progress. Another is that he has a barrister's preference for quick point-scoring, where slowly building up credibility would be wiser. But good lawyers at least study relevant previous cases. In this instance, Mr Howard and Mr Grieve (both barristers) have ignored them.

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Religious hatred

Free speech v religion

Dec 9th 2004
From The Economist print edition

An unlikely alliance defends the right to make jokes

Reuters

Hallelujah

LOW-CHURCH Christians are not usually thought of as having a rollicking sense of humour. But this week, a gaggle of British comedians, led by the rubber-faced Rowan Atkinson, internationally known as Mr Bean, defending the right to satirise religious faith, shared a platform with the stern but shining faces of the Evangelical Alliance, which claims to speak for over a million British churchgoers. “I don't agree with the things Rowan Atkinson says about Christianity, but I would go into battle for his right to be able to offend me,” explains Don Horrocks of the Alliance, in a Voltaire-like moment.

So where then, is the good fight that this odd alliance of lampooners and lampooned is preparing to fight? The dragon they hope to slay is a proposed change in the law that would extend the bar on inciting racial hatred to stirring up religious hatred.

David Blunkett, the home secretary, has insisted there is no threat to Mr Atkinson's skits on simpering clergy with singsong voices. The new law would be reserved for egregious hate-mongering; there will be no frivolous prosecutions. The Muslim Council of Britain, an umbrella group which has been lobbying hard for the “religious hatred” provision, makes a similar point. In its view, a recent change of tactics by ultra-rightists such as the British National Party has sharpened the need for legislation. “Since it is barred from insulting people because of their race, the far right has been focusing its verbal attacks on the Muslim faith,” says an MCB spokesman.

The evangelicals retort that a change in the law could poison, not improve, relations between faiths. Even if prosecutions were rare, the very possibility of criminal investigation would make Christians and Muslims intensely wary of each other.

Whatever the amendment's fate, evangelical Christians and Muslims are debating openly, and linking up on some public issues (such as opposing a recent law that allowed transsexuals to marry) while differing on others. Even the cautious, official voice of the Church of England is making itself heard on matters of topical concern. Take the new nativity scene at Madame Tussaud's, a waxwork museum, where the earthly parents of Jesus are displayed in the likeness of David Beckham and Posh Spice. Informed of this, a Church of England spokesman said, “Deary, deary me.”

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The BBC

Tough love for Auntie

Dec 9th 2004
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How Mark Thompson hopes to save the BBC by cutting it

“DESPITE its eccentricities and failings, it remains...the greatest force for cultural good on the face of the earth,” said Mark Thompson, director-general of the BBC, as he announced his reforms. Hubris is not Mr Thompson's only problem. He has to correct enough of the BBC's failings to persuade the government to fund it through the licence fee for another ten years, but also to avoid changing so much that he comes to be seen as the man who started its decline.

Much of Mr Thompson's programme is about cutting fat. A tenth or so of the BBC's 27,632-strong workforce will go in the new year, mostly from the back office. More cuts will come later along with 15% reductions in programme budgets. The plan to create a northern media centre by moving children's television and radio, sport and Radio 5 Live to Manchester, fits with the government's intention to move civil servants out of London and the south-east. And the BBC may sell or dispose of two of its divisions, Broadcast and Resources.

A big slice of the savings of £320m a year will be spent on revamping the BBC's schedules. That will address another of the government's worries. The public and Ofcom, the media regulator, have complained that the BBC's previous director-general, Greg Dyke, dumbed it down. The BBC says it will invest more in original British comedy and drama and in factual programmes and less on repeats and home-improvement and reality television.

Mr Thompson is reversing much that his predecessor did. Mr Dyke put freelancers on staff, which created the thousands of jobs now being cut. Andy Duncan, chief executive of Channel 4, points out that his whole organisation employs fewer people than does the BBC's personnel department.

Mr Dyke also favoured in-house production, with the result that between April 2000 and March 2003 the BBC failed in its statutory duty to give independent producers a quarter of television commissions. The government was not happy about that. It wants more competition between the BBC and independents.

Under Mr Thompson's plans, the BBC will allow independents to compete with in-house for half of television commissions. That does not go as far as Tessa Jowell, the culture secretary, wanted—according to a BBC executive, her aim was to cap in-house production at 50%, leaving the other half for independents, who are therefore disappointed. Nevertheless, it is a radical move, because it touches on the issue of how much in-house production the BBC needs.

Some people at the BBC are unhappy even with such a limited step. They argue that the independent sector is dominated by a few big reality-television producers who do not deserve public money. The BBC, by contrast, can set programming standards and act as a training ground—so long as it produces its own programmes.

Bigger independents do indeed dominate: five of them make 80% of all independent programming hours. But it is possible to pick small ones, of which there are plenty. Channel 4, which has no in-house production, works with 300, whereas the BBC uses 175, says Peter Bazalgette, chairman of Endemol UK, which makes “Big Brother”. If the BBC is going to give independents more work, he says, it should commission more from start-ups as well as from established names. That would also please the government.

Mr Thompson seems to have struck the right political balance. The plan is not riskily radical; and one person with sway over the BBC's future describes his measures as “a very, very good start”.

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Army reorganisation

Hoon's model army

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Sensible reforms may be undermined by too few troops

EVEN before a deal in Northern Ireland seemed near, the Ministry of Defence had plans for the resulting peace dividend. Although four infantry battalions may no longer need to be stationed in Ulster, that is not the main reason for the reform that the defence secretary, Geoff Hoon, is expected to announce next week.

Dealing with rogue states and terrorism requires an army that can quickly deploy and sustain forces in several different parts of the world at once. British troops are currently heavily committed in Iraq, Afghanistan and the Balkans. That has exposed long-standing inefficiencies in the army's traditional regimental structure. So a radical proposal, which looks like going ahead after it was approved earlier this week by the army's top brass, merges 24 infantry regiments (out of a total of 32) into seven super-regiments over the next four years. That is the most far-reaching reorganisation of the army since the end of conscription 42 years ago.

Naturally, this has provoked an outcry from traditionalists, mostly former officers. Much was made of the uncertain future of the Black Watch, a Scottish regiment—a poor reward for the courage of its soldiers, several of whom were killed during the regiment's deployment in central Iraq. Most military experts and currently serving senior officers argue that the new super-regiments will be better. More of the army will be able to go on difficult missions overseas, lessening the current overload on elite forces. The restructuring will also allow the recruiting of extra and much-needed engineering, logistical and intelligence units.

Mr Hoon also claims that although the number of infantry battalions will be cut from 40 to 36, the new battalions will be kept at their proper fighting strength. In this, he may be helped by the scrapping of the present complicated system by which regiments rotate between bases every few years. That is a major reason for the difficulty the army has in hanging on to seasoned, highly trained soldiers.

So far, so sensible. Unfortunately, the whole business has been clouded by more than just sentimentality about disappearing cap badges (in fact, they will probably be kept). The government's critics are convinced that the restructuring has less to do with operational efficiency than with Treasury-mandated spending cuts.

This is unfair, although it is true that were it not for budgetary stringency, the army might have chosen less painful options. The real case against the government is that it is unwilling to recruit the number of soldiers it needs for its interventionist foreign policy. Michael Clarke, the director of the International Policy Institute at King's College London, says: “They are doing the right thing, but what is reprehensible is that they are not doing it with higher numbers.”

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Public-sector pensions

Bloated and unsustainable

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From The Economist print edition

The huge and rising cost of public-sector pensions

OCCUPATIONAL pensions started in the civil service and then spread to the private sector. Defined-benefit schemes, offering pensions linked to years of service and final salary, became the norm. But the DB pension is now dying in the private sector as a result of decisions by many companies to close these expensive plans to new workers. On current trends, DB pension provision will become more and more concentrated in the public sector, where it began.

This will exacerbate the existing disparity between pension rights in the public and private sectors. According to the Pensions Commission, the public sector's share of occupational and personal pension wealth is double its share of total earnings. The public sector accounts for 17% of earnings and 18% of employment but 36% of the value of pension rights.

A pension system in which this gap widens still further looks politically and fiscally unsustainable. Taxpayers, most of whom work in the private sector, would have to foot a rising bill for generous and secure pension benefits that are increasingly confined to the public sector.

The public sector's unfunded occupational pension liabilities—mainly for teachers, the health service and civil servants—have been rising sharply. In 1995, they were worth £195 billion, 27% of GDP. By spring 2001, their value had risen to £350 billion. Two years later, it had jumped to £425 billion according to the Government Actuary's Department. The Pensions Commission adjusts this figure up to £475 billion—43% of GDP—on the basis of new private-sector pension accounting rules.

Local-government workers are covered by a funded scheme, but one that has sprung a big hole. The deficit amounts to around £30 billion, 25% of liabilities, says Helen Kilpatrick, who chairs the pensions panel of the Chartered Institute of Public Finance and Accountancy. This estimate takes into account planned reforms to reduce early retirement and to raise the usual pension age from 60 to 65. These changes will save around 2% of local-government pay. Even so, council tax—or grants from central government funded by taxes—will eventually have to rise considerably to plug the gap.

Similar reforms are being introduced across the public sector. The Cabinet Office unveiled plans on December 9th to raise the pension age for Britain's half a million civil servants from 60 to 65 in 2013; for new entrants, the reform will take effect in 2006. It expects a similar saving of 2% of pay. The civil service will also switch from a final-salary to a career-average scheme. This is likely to make aspiring Sir Humphreys unhappy since a final-salary plan disproportionately rewards workers whose salary rises steeply at the end of their career. However, the new benefit structure is not designed to save money; and some of the savings from raising the pension age will be recycled into benefits.

On December 2nd, the Treasury released estimates of future spending on unfunded public-service pensions. The forecasts take into account the planned rise in the pension age across the public sector. Even so, they show a rise in spending from 1.5% of GDP today to 1.8% in ten years' time and 2.1% in 20 years' time. According to Stephen Yeo, pensions specialist at Watson Wyatt, an actuarial firm, these projections look optimistic. The government's inadequate reforms are putting an expensive bill in the post for taxpayers.

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Company pensions

Protection racket

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Flawed pension-protection scheme

THE Pension Protection Fund (PPF), set up by the government and paid for by businesses, is to insure workers whose employers go bust with shortfalls in their pension funds. It is due to start up in April next year. But a single failed pension fund, which threatens to swallow up the whole of its first year's income, highlights how inadequate its resources are.

The battle is at Turner & Newall (T&N), a car-parts-maker that was bought in 1998 by Federal Mogul, an American company. In 2001, hit by huge claims relating to T&N's earlier use of asbestos, Federal Mogul went into bankruptcy protection in America, simultaneously putting T&N into administration. It soon became clear that Federal Mogul would not fund a big deficit in T&N's pension fund. The scheme, which has 40,000 members, was summarily closed in July when it was also announced that a £300m-£400m deficit existed on some £1.2 billion of assets.

If the trustees had chosen to wind the fund up, it would have cost £875m, and it was not clear that the money could be found. Instead, they negotiated with Federal Mogul and its creditors. On December 6th, those negotiations fell apart, leaving the scheme's members at risk of losing 70% of what they are owed.

Everyone agrees that the T&N members have done nothing wrong. Wouldn't the temporary “financial assistance scheme” the government has set up for funds wound up before May 2004 bail them out? No, it would not. There is only £20m annually in the pot, for all bust funds, not just T&N's. Besides, the T&N fund ran into trouble after May 2004.

So what about the PPF, due to start in April next year? It is going to cover broke funds only once it is up and levying its projected £300m annual charge. If the T&N fund is wound up now, the members might find themselves with no compensation. Surely, then, the trustees should wait a few months before winding up the T&N fund, thereby making it eligible for help from the PPF? That “moral hazard” points to the main flaw in the PPF enterprise: plenty of other companies could be waiting to dump their long-term liabilities onto a body that risks being overwhelmed from the day it opens its doors.

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Bagehot

Paisley's game

Dec 9th 2004
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Although he scuppered a deal on power sharing this week, Ian Paisley is intent on becoming first minister

SO THE Big Man, as Reverend Ian Paisley is known to his followers, said “no” after all. The only surprise is that there should be any surprise that Mr Paisley decided at the last moment to spike the latest attempt by the British and Irish governments to restore Northern Ireland's power-sharing executive.

Talk of a kinder, gentler Mr Paisley, suddenly desperate to take his place in history as a peacemaker after intimations of mortality brought on by illness last summer, is wide of the mark. But nor is he still the wrecker that he was for more than 30 bigoted, extremist years. After all, as the two governments outlined on December 8th, Mr Paisley's Democratic Unionist Party (DUP) and Sinn Fein, the IRA's political wing, appear to have come tantalisingly close to a deal. Whether or not there is a photograph of the IRA destroying its weapons—the issue on which the talks stuck—is a detail that should not be allowed to scupper a settlement between die-hard unionism and die-hard republicanism.

So what is Mr Paisley up to? Probably a more calculating and cynical game than either his admirers or many detractors realise. It may be that the only people who have Mr Paisley's measure are the leaders of Sinn Fein, whose cynicism and patience match that of their old enemy.

Just as Sinn Fein's Gerry Adams and Martin McGuinness marginalised moderate nationalism by exploiting their party's close relationship with the terrorists, so Mr Paisley undermined and then destroyed his political rivals—not just the brave and decent Ulster Unionist Party (UUP) leader, David Trimble, but also independent unionists opposed to the Good Friday Agreement who might one day have outflanked him. Mr Paisley's strategy has been to split unionism again and again, to make life miserable for any unionist leader rash enough to try something positive and to foment an atmosphere of crisis intended to frighten people into voting for him—much as people fearful of wolves might turn to a slavering guard dog for security.

Yet while the volume of Mr Paisley's fundamentalist rhetoric has rarely faltered, his actions have been a better guide to the direction in which he is travelling these days. Although his party condemned the Good Friday Agreement and vowed that it would “never sit down with the IRA or Sinn Fein”, the DUP took up its allocation of two ministerial jobs in the executive. Mr Paisley may have characterised David Trimble as “the traitor who let terrorists into government”, but the DUP was determined to be a part of that government.

Moreover, the DUP's Peter Robinson and Nigel Dodds proved themselves to be capable ministers. They enjoyed their jobs and did them without sectarian bias. Having enjoyed the pleasant taste of power and the perks of office, the DUP's leadership has badly missed both since the executive's suspension two years ago. Without admitting it, the DUP has become, in effect, a pro-agreement party.

The yearning for the executive's restoration sharpened 13 months ago when the DUP finally displaced the UUP as the dominant voice of unionism. Mr Trimble's defeat in the assembly elections had been sealed by the refusal of the IRA to decommission its weapons publicly and by Mr Paisley's contempt for his supposed gullibility. With Mr Trimble gone, the job of first minister of Northern Ireland was Mr Paisley's—if only he could find a way of squaring the circle he had created.

This week's shenanigans must be seen in that context. There is deep shock among Mr Paisley's traditional supporters, especially in his North Antrim constituency, that the “Doc” has travelled so far without bothering to tell them. That may partly explain what looks like his deliberate sabotage of this week's deal. Mr Paisley must be aware that he needs to do more to prepare the ground if he is to escape

the accusations of betrayal that he has so balefully levelled at nearly everyone else in the past. Insisting on photographic evidence of weapons decommissioning is one thing; saying that the “bloodthirsty monsters” of the IRA must don “sackcloth and ashes” looks like deliberate provocation. As one former constituency ally said: “The Big Man protests too much.”

The suspicion is that Mr Paisley thinks he can win more seats in the general election, expected in May, by showing he has not been “Trimbled”. Afterwards, from a position of strength, he can extract further concessions from the republicans. He may well get away with it. Unionists no longer have anywhere else to go and the DUP is a dissent-free zone: its deliberations are no more transparent than those of the IRA.

Big Man, rotten legacy

No doubt a deal will be done some time next year and Mr Paisley will duly be appointed first minister. It may, however, be a pyrrhic victory. He is not in good health and will by then be in his 80th year. Although he will claim to speak for unionism, many of his own supporters will believe he has sold out, while moderate unionists will hold him in contempt for his past behaviour and present opportunism. Mr Paisley's party and the Free Presbyterian Church that acts as its auxiliary arm have been formed so completely in his image that there is no guarantee of an orderly succession. And able though Mr Robinson, the perennial deputy, and Mr Dodds may be, it is hard to see either filling the Big Man's shoes.

But perhaps Mr Paisley's most enduring legacy will be the weariness and disillusion his style of politics has fostered. A poll published in June found that 66% of Northern Irish Protestants and 50% of Catholics were indifferent to devolved government. The people of Northern Ireland are grateful for the peace and prosperity the Good Friday Agreement has brought them. They may not be so happy with the sectarian carve-up to which it also looks like leading.

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Time to deliver

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Reuters

Indonesia has gone from near-dictatorship to vigorous democracy. Now it needs to ensure that its people reap the benefits, says Edward McBride

Get article background

INDONESIANS cannot eat democracy, sniffed Singapore's *Straits Times* before the last of Indonesia's three elections this year. Singapore's state-controlled press may not be the most dogged defender of political freedoms, but the newspaper has a point. Over the past six years, Indonesia has undergone a remarkable transformation from near-dictatorship to vigorous democracy, culminating in the inauguration in October of Susilo Bambang Yudhoyono, the country's first directly elected president. But ordinary Indonesians have little to show for it. Over the same period, the rapid growth in Indonesia's economy that had lifted millions out of poverty in the preceding decades slowed down dramatically, and for a time went into reverse. Unemployment has risen sharply. The new president now needs to harness his unprecedented mandate to get the economy moving again and give his compatriots a stake in their new democracy.

There is no questioning the magnitude of Indonesia's achievement since the call for *reformasi* gathered pace in 1998. In May of that year, massive protests forced the resignation of Suharto, the country's strongman of over 30 years. Since then, Indonesia's political life has changed beyond recognition. Elections, which once offered a choice of just three parties, now feature dozens. In place of the sleepy old parliament, which elected Mr Suharto unopposed seven times, there is a newly assertive body which churned through three different presidents in the three years following his resignation. Voters, too, are throwing their weight around: in choosing Mr Yudhoyono, they rejected the incumbent president, Megawati Sukarnoputri, and the big parties that supported her. The courts, which used to follow the regime's bidding, have won complete independence. The many disparate regions of this vast archipelago, previously subservient to the central government's whims, now hold all but a handful of the powers that used to be wielded from Jakarta.

The army, which formed the bedrock of Mr Suharto's regime, is back in the barracks, although never far away. Active servicemen can no longer moonlight in the bureaucracy. The Ministry of Defence is now headed by a civilian. The police, formerly just another repressive branch of the armed forces, have been hived off and redirected from fighting opponents of the regime to fighting crime.

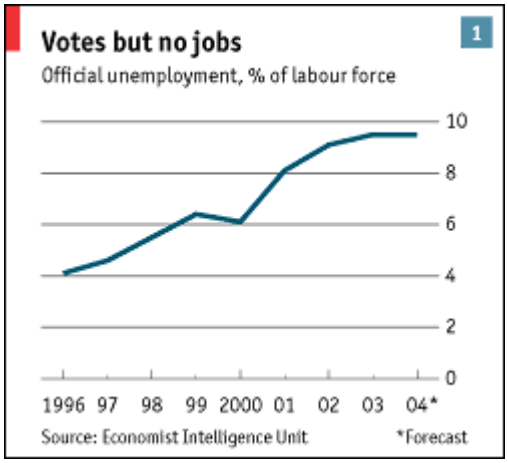
Instead of a handful of cowed media, Indonesia now boasts a cornucopia of competing television channels, magazines and newspapers—state-owned and private, local and national, specialised and

generalist, in many languages—to cater to every conceivable taste and interest. The same applies to trade unions, NGOs and other pressure groups, which have proliferated throughout the country. Perhaps the best indication of public enthusiasm for democratic diversity is the election turnout, which was around 80% in each of this year's elections (one for parliament and one for president, in two rounds).

Yet whereas Indonesian voters are doing their bit for democracy, it has not done much for them. Under Mr Suharto's authoritarian regime, the economy grew by an average of 7% a year; since he stepped down in 1998, it has managed only half that rate (although thanks partly to problems of Mr Suharto's making). In that year itself, as the Asian economic crisis took hold, the economy shrank by 13%. Growth is now up again, to perhaps 5% this year, but remains much lower than in the late 1980s. The economy regained its pre-crisis size only in 2002. Measured per person, it did not recover until this year.

With such feeble growth, many Indonesians are out of work. Before the crash, the unemployment rate never rose above 5%; now it is over 9% (see chart 1). Economists estimate that another 30% of the workforce is underemployed. And these figures are climbing steadily as some 2m young Indonesians enter the job market every year.

No wonder, then, that Indonesia's admirable progress on poverty reduction has also stalled. Between 1965 (when Mr Suharto seized power) and 1996, the proportion of Indonesians living in poverty fell from 60% to 16%, by the World Bank's measure. During the crisis the poverty rate shot up, and has only recently fallen back to its 1996 level. The number of Indonesians subsisting on less than $2 a day—slightly above the Bank's poverty line—remains a worrying 50%, just as it was in 1996.



Indonesians are also less secure than they were in Mr Suharto's day—except, of course, for the bloodbath that accompanied his rise to power, and the lesser violence surrounding his removal. Muslims and Christians continue to clash periodically in the provinces of Maluku and Central Sulawesi. Indigenous tribes in Kalimantan have mounted pogroms against immigrants from other parts of the country. The long-simmering insurgency in Aceh, at the country's western tip, has boiled over into outright war. At the opposite end of the country, in Papua, separatist agitation continues.

Terrorism has become another blight in recent years. The bomb that killed some 200 people in the resort of Kuta in Bali in October 2002 was the deadliest attack the world had seen since September 11th 2001. Subsequent bombings have fortunately claimed far fewer lives, but have helped to cement Indonesia's undeserved reputation as a hotbed of Islamic extremism.

For that reason, if no other, the outside world will be following Mr Yudhoyono's progress with concern. An ill-governed and impoverished Indonesia would inevitably export terrorism, piracy, pollution, instability and illegal immigrants to its neighbours. It would also disrupt shipping in the Strait of Malacca, a transit point for a quarter of the world's seaborne trade.

A model of sorts

Conversely, access to Indonesia's enormous and underexploited natural resources could prove a boon for the global economy in an era of high commodity prices. On a more abstract level, Indonesia is often seen as a bellwether for developing countries, especially Muslim ones. With 220m people, 85% of whom are Muslim, Indonesia is the biggest Muslim country in the world, and the fourth most populous of any faith. At the moment, it is the best proof of the cherished belief that Islam and democracy can co-exist. It is the only East Asian member of the Organisation of Petroleum-Exporting Countries. In its heyday, it was the linchpin of stability in South-East Asia and a model of rapid development. The Non-Aligned Movement grew from a summit in Bandung in 1955, and the headquarters of the Association of South-East Asian Nations are in Jakarta.

For now, however, most foreigners regard Indonesia as more of a cautionary tale than a model. That is a judgment Mr Yudhoyono must reverse. For the fate of his presidency rests on the economy, and the fate of the economy rests on attracting foreign investment.

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Enemies of promise

Dec 9th 2004
From The Economist print edition

The economy has great potential, but plenty of things get in the way

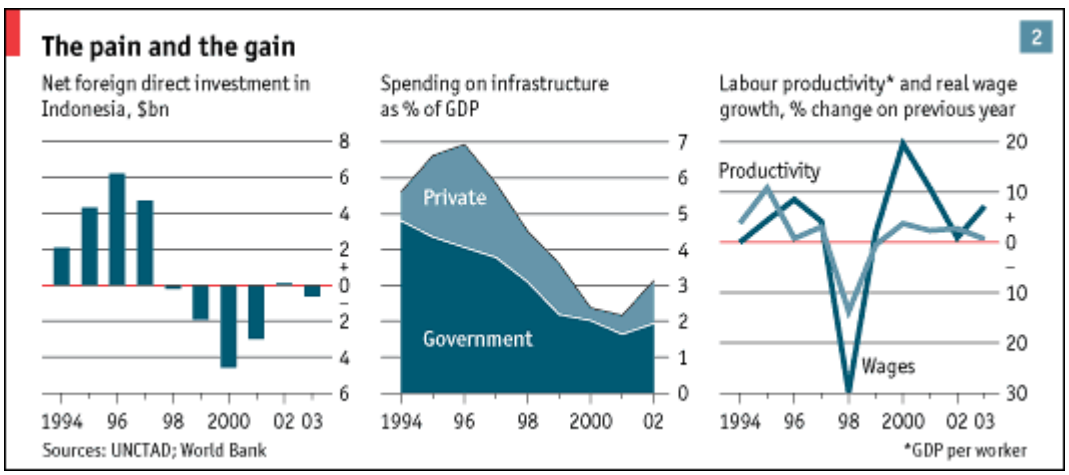
Reuters

The infrastructure investment is running late again

MEASURED against the darkest days of the Asian crisis, Indonesia's economy is doing quite well. The local currency, the rupiah, has appreciated dramatically, thanks in part to capital inflows attracted by the government's asset sales. The improvement in the exchange rate, in turn, has helped reduce public debt from almost 100% of GDP in 2000 to under 60% now. Inflation, at 6%, is manageable. Real interest rates have reached their lowest point in Indonesian history. Overall growth, although below Indonesia's long-term average, is at least positive, and rising. The stockmarket has hit a series of highs during this year, propelled first by surprisingly peaceful elections and then by news of Mr Yudhoyono's victory.

But one number lags well behind the others: investment. Almost all the current growth comes from consumption. Investment, which before the crisis hovered around 30% of GDP, has since fallen to about 20%. Last year's figure of 18% was the lowest since the early 1970s. What is more, investment has shifted away from the factories that once supported a burgeoning manufacturing industry. Nowadays, over 80% goes into property.

Foreigners are the leeriest. For five out of the past six years, foreign firms took more money out of the country than they put into it (see chart 2). True, foreigners are piling into the stockmarket, but that only serves to accentuate their reluctance to make longer-term investments.



In part, this dearth of foreign direct investment reflects the growing allure of China. Indonesia's roller-coaster business cycle also plays a role. During the crash, the fall in the rupiah and the rise in interest rates left businessmen unable to pay their creditors. Many companies went bankrupt, which threw people out of work. The resulting fall in purchasing power and demand for consumer goods accelerated the downward spiral. The firms that survived were left with enormous excess capacity. Sensibly, they are waiting for faster economic growth to take up the slack and improve their finances before risking any new investment. Capacity utilisation is only now reaching the sort of level—around 90%—that would prompt companies to expand again.

But there is more to Indonesia's woes than sluggish domestic demand. Other crisis-hit countries, such as Thailand and Malaysia, compensated for shrinking domestic demand by exporting their way out of trouble. But Indonesia's exports account for a lower share of output now than they did before the crisis—and they are currently flattered by the high prices fetched by the country's oil and gas. Many exporters have simply packed up and left. Sony made headlines by closing down an audio-equipment factory last year. Several footwear companies have decamped to Vietnam and China. The World Bank calculates that employment in manufacturing has been shrinking for the past three years in a row. The head of the national employers' association has given warning of “de-industrialisation”.

Obstacle course

The World Economic Forum ranks Indonesia 69th out of 104 countries for its international competitiveness, far behind regional rivals such as Malaysia, Thailand or China. To understand why, picture a potential investor visiting Indonesia for the first time. Before he even sets out on his journey, he will spend several hours at an Indonesian embassy securing the appropriate visa. Your correspondent, for example, had to pay five visits to sort out his papers. On arrival in Jakarta, desultory passport inspectors may keep him waiting in line for an hour. His taxi driver will refuse to start the meter, demanding an extortionate fare instead. Congested roads will drag out his trip into town. As he sits in stationary traffic, he begins to wonder whether one of the vehicles around him might contain the car bomb that anti-western terrorists are said to have stashed away somewhere in Jakarta.

Those first few hours sum up all the problems of doing business in Indonesia: excessive red tape, unproductive labour, bad infrastructure, a lack of respect for the rule of law and a reputation for lax security. In a recent study, the World Bank calculated that in Indonesia it takes an average of 151 days to complete all the paperwork required to start a company, against 30 in Malaysia and eight in Singapore. The relevant permits cost 131% of Indonesia's average annual income per head, compared with 20% in the Philippines and 7% in Thailand. Other procedures are equally expensive and time-consuming. Registering a property in Indonesia will set you back 11% of its value, against 5.5% in Vietnam and 2% in Hong Kong. Collecting money from a recalcitrant debtor takes an average of 570 days in Indonesia, but only 241 in China. And these measures assume that all the official deadlines will be met and no one will ask for bribes—which in Indonesia is highly improbable.

Indonesian labour, too, represents bad value for money. Wages have risen far faster than productivity in recent years (see chart). In Jakarta, for example, the minimum wage rose by 50% in real terms between 1997 and 2002, despite the crisis. Indonesian workers, the World Bank calculates, are far less efficient than their Indian and Chinese counterparts. They are also harder to get rid of. Officials from the ministry of labour must approve every sacking. Moreover, under Indonesian law employees are entitled to two months' severance pay for every year they have worked for a company. Ways round these restrictions, such as short-term contracts or outsourcing, are also strictly controlled. Until recently, companies even had to pay off workers who left voluntarily. They still cannot fire a worker caught committing a crime until he is found guilty by a court.

These disastrous rules were drawn up in response to the policies of Mr Suharto, who kept unions on a short leash. After his downfall, sympathetic parliamentarians rushed to improve the lot of the workers. But in their haste they failed to distinguish between employees' right to organise, which badly needed strengthening, and their living standards, which they also tried to improve through legislation. Hundreds of new unions sprang up, many of which, businessmen gripe, are simply a cover for extortion rackets. In central Jakarta, hardly a day goes by without a union protest of some sort. The day after September's presidential run-off, when it became clear that Mr Yudhoyono had won, a number of former employees of Dirgantara Indonesia, the loss-making state-owned aircraft manufacturer, showed up on Mr Yudhoyono's doorstep to try to get their jobs back.

Potholes and brown-outs

Spending on infrastructure is another concern. It plummeted from almost $16 billion in 1996 to $3 billion in 2001. According to news reports, brown-outs are imminent in Java, the industrial heartland. In the rest of the country they are already common. As it is, only half the population has access to electricity. Spending on roads has fallen even faster than spending on infrastructure as a whole, and the maintenance budget has fallen faster still. Population growth is now outpacing the growth in the road network.

The poor, as usual, bear the brunt. Fewer than 20% of the poorest fifth of Indonesians have access to clean water. Rural roads get less investment and are in worse shape than the national network. Nearly 99% of the population lack modern sewerage, which means the poor are often living near or even washing in contaminated water. In 2001, the Asian Development Bank estimated that health problems linked to poor sanitation cost Indonesians the equivalent of 2.4% of GDP. And infrastructure problems can only get worse as more Indonesians move to the cities.

The government simply does not have the cash to fix all this itself. Jusuf Kalla, the vice-president, has mused instead about forcing state-owned banks to make loans for road-building projects. But it would make more sense to concentrate on attracting private investment—which before the crisis accounted for almost half the money spent on infrastructure. Crisis or no crisis, investors continue to pour money into mobile telephones, which are now more numerous than landline connections.

Despite the obstacles, plenty of companies succeed in making money in Indonesia. Banks, for example, are back in the black as they diversify away from the corporate loans that brought them so much trouble during the crisis. Consumer credit grew by 40% last year. Spreads have improved as interest rates keep coming down. Non-performing loans have fallen to just 6% of the total, less than in Thailand or Malaysia.

Retail therapy

Credit growth, in turn, is feeding a consumer boom. Private consumption accounted for over 90% of economic growth in 2002, and 80% last year. Ritzy new malls are springing up not just in Jakarta, but in provincial capitals too. Starbucks now has outlets in Medan and Surabaya, and McDonald's is dishing up burgers in several cities in Borneo. Honda recently opened a new motorbike plant. Unilever, whose local subsidiaries make everything from floor cleaner to soy sauce, is in the middle of a $500m investment spree. It has even moved some production from factories in Malaysia and Australia to Indonesia.

There is hope for Indonesia's exports too. Between 2001 and 2003, those to China rose by 48%. The World Bank reckons that Indonesia is enjoying a growing comparative advantage in wood, furniture, paper, tobacco, palm oil, coal and minerals. The government also signed 15 new oil and gas contracts last year, compared with just one in 2002.

China's thirst for commodities, and the concomitant rise in global prices, creates a unique opportunity for Indonesia. Yet investment in mining last year was just $177m, compared with $2.6 billion in 1997. The problem, says Noke Kiroyan, head of an association of mining companies, is Indonesia's antiquated mining law. Every government since 1998 has been promising to come up with a new one. Since most investments in the sector have a lifespan of 30 years or more, it would be foolhardy to invest before the new law is enacted.

But mining companies are not the only ones to be discomfited by the law. Courts have been known to impound entire firms from their bewildered owners. The police sometimes sling managers into jail on flimsy charges. And the army is not above extortion. Doing business in Indonesia, in short, is totally unpredictable. James van Zorge, of Van Zorge Heffernan and Associates, a local consulting firm affiliated to the Economist Intelligence Unit (a sister company of *The Economist*), argues that more than anything else, investors crave legal certainty. To provide it, Mr Yudhoyono must crack down on corruption and improve Indonesia's justice system.

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The importance of going straight

Dec 9th 2004
From The Economist print edition

Pervasive corruption is bad for business

AP

It's got to stop

WHEN in 1999 Indonesia held its first free elections in over 40 years, Saldi Isra, like many of his compatriots, expected great things. The energetic university lecturer decided to take an interest in the activities of the local parliament in his home province, West Sumatra. Its members were responsible for choosing the provincial governor, so he lobbied them to select a reform-minded leader in keeping with the spirit of the times. When they plumped instead for a conventional apparatchik, Mr Saldi decided that they were not to be trusted.

So he began to scrutinise the provincial budget. The 55 local lawmakers, it turned out, had awarded themselves various perks and allowances amounting to 300m rupiah per person per year, on top of their normal salary. Mr Saldi earns 19m rupiah a year. Many of these overnight plutocrats had traded in their clapped-out motorbikes for expensive cars or moved to more fashionable neighbourhoods. When Mr Saldi confronted them, they blithely declared that they had the right to spend the provincial budget however they pleased. So Mr Saldi complained to the governor, the police, the prosecutors and the courts, all of whom ignored him.

Mr Saldi's story, sadly, is commonplace. Indonesia Corruption Watch, a local non-governmental organisation, has uncovered no fewer than 67 similarly suspect budgetary manoeuvres in other local assemblies. Corruption addles Indonesia at every level, from town councils to the national cabinet, and in every branch of government. Members of the national parliament and the Supreme Court freely admit that their colleagues demand bribes to discharge their normal duties.

Conversely, few traffic accidents are reported to the police, for fear that greedy officers will add to the victims' woes by impounding vehicles and extorting huge sums for their return. When Akbar Tandjung, a former cabinet minister and speaker of the lower house of parliament, was tried in 2002 for channelling government money to his political party, he argued that he was simply following the orders of the president of the day—a defence the Supreme Court accepted. No wonder that Transparency International, an anti-graft NGO, ranks Indonesia as among the most corrupt countries in the world, on a par with Angola and Turkmenistan.

This epidemic of graft has a devastating effect on business. At the most basic level, much of the economy remains informal, thanks in large part to grasping bureaucrats who would inevitably demand pay-offs from any company that crossed their path. That deprives the government of tax revenue and makes it hard for small firms to take out loans or settle disputes. Legitimate businessmen complain that their tax bills are entirely unpredictable, because the amount they pay depends not so much on the tax code but on the avarice of their particular inspector. Indonesia's penchant for bureaucracy provides a long line of other officials, from fire inspectors to liaison officers at the ministry of labour, with all manner of opportunities to gouge hapless businessmen.

A law unto themselves

In theory, the courts should provide redress for victims of corruption. In fact, they simply practise a more institutionalised form of extortion. Take the Indonesian subsidiary of Prudential, a British insurance firm. Earlier this year a court declared the company bankrupt, despite its sound finances, on the basis of one

disputed debt to a former agent.

The ruling was an unwelcome reminder of a similar case in 2002, when the local subsidiary of Manulife, a Canadian insurer, was declared bankrupt for failing to pay a dividend. If such practices were adopted in other countries, half of Wall Street would be out of business. At the time, Manulife claimed that the judges concerned had been bought, although a government inquiry later exonerated them. After a great hullabaloo, the Supreme Court overturned the decision (as it did the ruling in the Prudential case). In September, the parliament amended the bankruptcy laws to give the courts less leeway in such cases.

The police, too, pursue vendettas against well-heeled foreigners. Earlier this year, various NGOs accused Newmont, an American mining company, of polluting a bay in North Sulawesi province. The police quickly threw five of the company's executives into jail, in the face of much conflicting evidence and before a government task-force had completed its investigation. After an outcry, it released them.

But imprisonment has become a risk foreign investors have to reckon with. The police now want to arrest several employees of Karaha Bodas, an energy firm which, coincidentally, has just won a $300m lawsuit against the government. In another case, which has recently come to light in Papua, the police have been confiscating illegally felled timber and selling it back to the culprits. To replace the logs that kept disappearing from the impounded stocks, they confiscated fresh logs from another timber merchant.

Abdul Rahman Saleh, the attorney-general and a former Supreme Court judge, admits that the entire legal system, including the police and the prosecutors, is mired in corruption. Even his predecessor as attorney-general is under investigation. The problem, he says, is that Indonesia's counter-corruption efforts involve neither carrot nor stick: civil servants' salaries remain laughably low, and greasy-palmed officials face no credible threat of punishment. Kwik Kian Gie, an ex-minister and a member of Miss Megawati's Indonesian Democratic Party of Struggle (PDI-P), highlights an even bigger problem: the political elite, including many of his colleagues in the PDI-P, are themselves corrupt, so it is not in their interest to set up effective mechanisms to fight corruption.

Enter the graft-busters

With Mr Saleh as attorney-general, that might change. What is more, a whole raft of new counter-corruption agencies have just started work, strengthening the hand of would-be graft-busters. The most important of these is the Corruption Eradication Commission. Its special prosecutors can investigate any suspected misconduct involving government officials believed to have cost the state more than 1 billion rupiah, and have wide-ranging powers. All senior bureaucrats are supposed to provide the commission with a detailed account of their financial position, and must tell it about any attempts at bribery. The government has no authority to interfere.

Despite these impressive powers, the commission has got off to a slow start. After a year in operation, it has completed only two investigations. These involve a provincial governor and some senior ministry officials—bigger cheeses than the ordinary prosecutors have ever laid hands on, but not quite the calibre that the public had been expecting. Logistics play a part, according to Erry Riyana Hardjapamekas, the number two at the commission. For the time being, he explains, it is limited to investigating complaints from the public, because it has not yet managed to assemble a crack team of prosecutors to initiate probes of its own. Eventually, though, he hopes to look into more incendiary matters, such as the business dealings of Mr Suharto's children.

But the biggest obstacle to the commission's work, Mr Erry concedes, was the attitude of the previous government. It dragged its feet over the nomination of judges to the special anti-corruption court that will hear the commission's cases, and it ignored the commission's order to suspend an official under investigation. The commission is not allowed to publish officials' wealth declarations. Anti-corruption NGOs also point out that three of the five commissioners installed under Miss Megawati's government are less than committed to the fight against graft.

The commission was created to bypass corruption within the ordinary criminal justice system. But moves are afoot to clean that up too. In July, parliament passed a law creating a Judicial Appointments Commission, which will nominate candidates for the Supreme Court (subject to parliament's approval) and monitor the conduct of all Indonesian judges.

Even without the commission, the Supreme Court has already begun to set its own house in order. The current chief justice, Bagir Manan, successfully lobbied parliament for the power to appoint non-career

judges, who are considered more open-minded and less corrupt. He is trying to deal with the huge backlog of cases at the Supreme Court by encouraging arbitration. At the same time, the Supreme Court is disciplining more insubordinate judges. Five have been dismissed in the past six months. Reformist judges used to despair at the state of Indonesia's judiciary; nowadays they are full of optimism.

Most of this process is out of Mr Yudhoyono's hands. Recent legal reforms have taken all powers over the judiciary away from the other branches of government, save for setting and disbursing the courts' overall budget. Parliament could help by setting aside more money for salaries: some junior judges make barely 1m rupiah a month, not enough to buy a plane ticket from Jakarta to their more remote postings. It should also restrict the right to appeal to the Supreme Court. At the moment, that court is obliged to hear all challenges to criminal convictions carrying a sentence of a year or more, and all appeals in civil cases of any kind. In one recent case, the berobed judges solemnly adjudicated between a pair of irate farmers feuding over three old hoes.

The president, meanwhile, can play his part by pushing for reform of the police and prosecutors. Mr Saleh wants to expand the role of the Judicial Appointments Commission to monitor them both. Both also need better training and more pay. At the moment, all the brightest law students head straight for private practices. As a result, few prosecutors can read Dutch, the language of Indonesia's most important legal precedents.

The police, for their part, are desperately short of equipment. Only half of the marine division's 300 boats are in working order, observers say, and even those are often idle for want of fuel. Before America donated some batons, riot police were using rifle butts for crowd control, so demonstrators sometimes ended up getting shot.

But there are some encouraging signs. A western diplomat describes how the police themselves approached his embassy for help with an anti-graft campaign. Now that they are no longer part of the army, the police are gradually reducing their emphasis on military training and tactics. New divisions have been set up to tackle modern crimes such as money-laundering and computer fraud. Community policing has become all the rage.

Mr Yudhoyono wants his government to lead by example. He speaks of “shock therapy” against graft. Yet only six of the cabinet's 34 members submitted a breakdown of their wealth by the president's deadline. Only one civil servant has ever reported receiving a gift, even though the law requires all of them to do so. When the governor of Jakarta announced that he would enforce the ban on presents during Hari Raya, Indonesia's biggest holiday, local merchants complained that he was putting them out of business. Sympathetic parliamentarians formed a fact-finding team to investigate their plight.

In the end, the best defence against corruption is the vigilance of activists like Mr Saldi. Having failed to elicit any interest from the police and the prosecutors in the shady doings of West Sumatra's provincial parliament, he alerted the media. Local newspapers and magazines took up the story with gusto, helping to stir up public indignation. Pressure groups organised protest marches. Demonstrators even managed to hoist a banner over the parliament building, labelling it a den of thieves.

Name them and shame them

All this shamed provincial prosecutors into action at last. They started proceedings against 43 of West Sumatra's 55 provincial MPs, who to general astonishment were all found guilty. A military tribunal is currently trying another six. Only four members are likely to escape punishment: one who refused the suspect pay-outs, another who returned them, and two who have died. The prosecutors have now turned their sights on the governor, for allowing the parliamentarians' crooked spending schemes to go ahead.

Inspired by this example, and chastened by public protests, prosecutors are now bringing similar cases against 27 local assemblies around Indonesia. Hardly a day goes by without the media breaking another budget scandal. In West Sumatra alone, cases are under way in six of the province's 14 cities and regencies, encouraged by people like Mr Saldi.

Unfortunately, all these prosecutions may yet fail. A misguided clause in the law governing the operation of local parliaments, it turns out, may have inadvertently sanctioned the looting of public funds. This oversight exemplifies Indonesia's boldest, most controversial and least well-thought-out constitutional reform of recent years: the new system of regional autonomy.

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Thousand-island dressing

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How far should regional autonomy go?

Reuters

Still waiting for peace in Aceh

IT IS impossible to exaggerate Indonesia's diversity. The country stretches for 5,200km (3,200 miles) from west to east—further than from Los Angeles to New York, or from London to Baghdad. It consists of more islands than anyone has been able to count. Most estimates put the number at over 17,000, ranging from tiny coral atolls to vast, mountainous landmasses like Sumatra, Borneo and New Guinea.

Indonesians speak perhaps 500 different languages—although, again, the exact figure is anybody's guess. They practise five religions officially, and many more on the side, with innumerable sub-sects and variations. Racial differences, between lighter-skinned Austronesians and darker Melanesians, for example, or between indigenous groups and immigrants from China, India and Arabia, are obvious. Many ethnic divides, for example between the Sundanese of western Java and the Javanese of the centre and east, are equally strongly felt. Not many outsiders have ever heard of Buginese, Banjarese or Bantenese, yet Indonesia has millions of all three. And in places such as Borneo and Papua, ethnic labels subsume a host of smaller, often hostile tribes and clans.

No two regions are alike. Riau is flat and swampy, whereas neighbouring West Sumatra is made up of towering volcanoes and narrow, fertile valleys. The people of Sumba build tall, conical dwellings, like witches' hats, whereas Borneo's Dayaks traditionally live in communal longhouses. The staple of Bali is rice, that of Maluku is sago. When it is raining in Aceh, it is dry in Flores and snowing in the highlands of Papua.

The differences in development are even more stark. Provincial income per head in East Kalimantan is 12 times that in East Nusa Tenggara. Yogyakartans live 13 years longer, on average, than the people of West Nusa Tenggara. Barely 20% of the people of West Kalimantan have access to clean water, against over 70% of Balinese.

Indonesians themselves cherish these distinctions. Stereotypes abound: Javanese, it is said, are impassive and oblique, whereas Batak and Buginese are thought to be plain-speaking and passionate. Papuans stink, according to a common prejudice. Tensions between locals and immigrants are common. A third-generation resident of Sulawesi will still identify himself as Balinese, say, even though he has never been to his claimed homeland. Such animosity can spark pogroms, such as the anti-Chinese riots in Jakarta and Solo in 1998, or the massacres of Madurese immigrants in Borneo in 1997 and 2001.

Small wonder, then, that only a few years ago pundits were predicting Indonesia's imminent break-up. After all, East Timor won its independence in 2002. Secessionists in Aceh and Papua, at the western and eastern extremes of the country, want to follow suit. The people of potentially wealthy provinces such as East Kalimantan and Riau have long grumbled that Jakarta siphons off all the revenue from their oil and gas without providing anything in return. In general, Java is thought to pre-empt natural resources and churn out haughty soldiers and bureaucrats. Mr Suharto repressed complaints and preserved unity by brute force. A democratic government, many observers worried, would not be able to handle local grievances.

To each their own

To meet such concerns, the government of President Abdurrahman Wahid in 2001 introduced a sweeping

form of regional autonomy. This granted cities and regencies (the level of administration below provinces) wide-ranging authority over all areas of government apart from monetary affairs, foreign relations, justice, religion, and security and defence. It guaranteed that the central government would transfer at least 26% of state revenue to regional authorities, as well as allowing them to issue bonds and levy various taxes. Regions also got to keep a share of revenue from natural resources, ranging from 15% of income from oil to 80% of that from forestry and fisheries.

In Kutai Kartanegara, an oil-soaked regency in East Kalimantan, the results are plain to see. Just a couple of years ago, few of the roads were paved, reminisces a local politician; now a four-lane highway links Tenggarong, the regency's capital, to the rest of the province. The road leads to a soaring new suspension bridge over the Mahakam river, which used to be the regency's main artery. The sleepy capital, centred on a square of patchy crab-grass, now boasts a five-star hotel and a university. Lofty marble-clad office buildings tower over dilapidated wooden houses perched on stilts above the water. An international airport is in the works.

Syaukani, the regent, as the head of a regency is known, explains that Kutai's budget has risen from 400 billion rupiah to 2 trillion since the autonomy law took effect, even as it lost two-thirds of its population to other regencies. In addition to putting in the new infrastructure, he has used the regency's windfall to abolish tuition fees at local schools. He hands out monthly stipends to veterans and to the poor. He has also given motorbikes to teachers who work in remote areas to cut down on absenteeism, subsidised hand tractors to farmers and so on. But problems abound, even in a place as rich as Kutai. The area was so neglected in the past, Mr Syaukani complains, that it is difficult to find skilled locals to implement his policies.

According to Muhammad Darlis, one of Kutai's representatives in the provincial parliament, villages in the regency have nothing to show for the billions of rupiah channelled to them. He suspects that much of the money has been embezzled. He also argues that Mr Syaukani is pursuing misguided development schemes, including a quixotic plan to turn Tenggarong into a popular tourist destination. He has already spent a fortune building a planetarium, a cable car and a viewing tower, which looks out over nothing in particular. Now he is constructing a fun park and resort on an island in the river.

In short, Mr Syaukani is a little rajah, as Indonesians call the new generation of rich and powerful regents. He keeps a menagerie of monkeys and peacocks in the grounds of his office. Inside, a lucky fish, imported from Singapore for $2,000, describes languid loops around a purpose-built tank. Petitioners fill the waiting room and spill on to the steps outside. Whenever the great man appears, a bevy of bureaucrats rushes forward to beg for his signature on some document or other. The regional army commander, various bankers and businessmen and a knot of journalists also wait patiently for an audience, often for hours at a time.

Mr Syaukani's gain, of course, is another regent's loss. The higher proportion of revenue going to resource-rich regions has necessarily reduced the funds available to other, less favoured areas. There is an element of redistribution in the complex formula governing the central government's transfers to the regions, but disparities are still on the rise: cities and regencies in the richest province receive 32 times

more revenue, on average, than those in the poorest one. Naturally, regents of poor provinces feel short-changed and are trying to raise money any way they can.

Regional Autonomy Watch, a pro-business lobbying group, tracks the many new money-making schemes cooked up by local governments. Some two-thirds of them, says Agung Pambudhi, its director, are arbitrary, illegal and harmful to business. One regency, he says, attempted to levy a tax on all logos used as a form of advertising, whether on packaging, T-shirts or bumper stickers. Another one taxes businesses on the generators they keep to guard against power cuts. A third charges firms to use their own parking lots. The most common scheme involves levying fees on trucks driving on local roads, or crossing regency boundaries, or undergoing mandatory inspections.

The central government can void local regulations that conflict with national laws, and has done so over 300 times since 2001. But only 40% of regencies and cities bother to inform the centre of the measures they are taking, according to Mr Agung. The government, for its part, is slow to review the few regulations that it does hear about. That may be one reason why regents have continued to issue logging permits, in defiance of the centre's insistence that it must endorse their approval. Forestry firms are unsure whether their activities are legal or not. But local officials know that the central government has over 400 regencies and cities to keep track of, and little stomach for a fight if it catches them doing anything wrong.

Parliament has amended the autonomy law in an attempt to bring wayward regents and mayors under control. Starting next year, these office-bearers will be directly elected rather than chosen by the local parliament. That will make it harder for candidates to buy their way into office, and should ensure that the most capricious and incompetent ones eventually get weeded out. The central government could also take advantage of its right to define “standards, norms and processes”. By one interpretation, this means that local governments should be responsible only for administrative decisions, not policy. At the very least, the central government could lay down firm rules on what services local governments must provide, and to what standard.

In the meantime, the amended law gives provincial governments some authority to supervise cities and regencies on behalf of the centre. Some argue that power has been devolved to the wrong level and should have been handed to the provinces in the first place. After all, they are fewer in number, easier to monitor and have more people to do the job.

Certainly it would make sense to plan infrastructure projects at a higher level, to avoid building hospitals with the same specialisation in adjacent regencies, say, or having new roads end abruptly at the city limits. But the legislators who drew up the original autonomy law feared that devolution to the provinces, many of which are big enough to be self-sufficient, might foster separatism. So they chose cities and regencies instead, because they reckoned that these would not be large enough to break away.

Indeed, there are signs that the authorities are trying to sabotage provincial autonomy in the two places that actually have it: Aceh and Papua. Mr Wahid's government granted the pair “special autonomy” in recognition of their distinct history and culture and their singular disenchantment with integration into Indonesia. Aceh resisted Dutch colonisers longer than any other part of Indonesia, and has been rebelling against the government in Jakarta, on and off, since the 1950s. Papua was not integrated into the country at independence in 1945, but only after a dubious referendum in 1969.

Aceh is more devoutly Islamic than the rest of the country, whereas Papua is tribal and Christian. Both are poor, despite a wealth of natural resources. Both have armed separatist movements, although the Free Aceh Movement (GAM) is much more of a force to be reckoned with than the Organisation for Papuan Independence (OPM). And both have experienced abuses at the hands of soldiers sent to crush the insurgents.

The limits of autonomy

In essence, special autonomy gives the two provinces a greater share of revenue from oil and gas, and extra powers to preserve local culture. In Aceh, that means the freedom to institute a mild form of Islamic law, whereas in Papua a council of indigenous leaders is meant to defend local interests against the effects of widespread immigration from the rest of Indonesia.

Unfortunately, Miss Megawati's government undermined these concessions. It divided Papua into three provinces, throwing the whole special-autonomy project into legal limbo. It ensured that the indigenous

council never met, and beefed up military operations against the OPM instead. In Aceh, it aborted peace talks with GAM, declared martial law and began a military campaign which, human-rights groups say, has claimed the lives of many innocent civilians.

Mr Yudhoyono, to be fair, resisted some of these steps while serving as Miss Megawati's co-ordinating minister for security. He says his government's top priority now is to bring peace to both provinces. But he has not yet convened the indigenous council, nor agreed to resume talks with GAM. Instead, he is offering an amnesty for rebels and is promising to speed up local development, a policy that is unlikely to bear fruit in the middle of a war. Djali Yusuf, a former army commander in Aceh, has joined Mr Yudhoyono's staff, prompting fears of further strong-arm tactics. The army has already killed more guerrillas in Aceh than it thought existed at the beginning of its campaign, and no end to the fighting is in sight. Meanwhile the despised special forces, which had withdrawn from Papua, have recently returned to the province.

Mr Yudhoyono is doubtless sincere in his desire to see the army improve its conduct and win the trust of Papuans and Acehnese. But that will not happen without clearer guidance from the top. As it is, only junior soldiers ever seem to get punished for human-rights abuses. To general incredulity, for example, the courts found that the seven soldiers who murdered Theys Eluay, a Papuan independence activist, were acting on their own initiative, without orders. No Indonesian official has been punished for the ransacking of East Timor after its citizens voted to secede from Indonesia, despite the creation of a special tribunal to bring the guilty to justice. To ensure close scrutiny of the army's conduct and dispel the idea that the government has something to hide, Mr Yudhoyono could at least overturn the ban on foreign journalists and researchers visiting Indonesia's trouble spots.

Regional autonomy has undoubtedly channelled more money to the regions, placating disgruntled local elites. But there is little sign that it has made local government more responsive or improved the quality of services for ordinary Indonesians. Mr Yudhoyono needs to stand up to those who are undermining regional autonomy, be they ill-disciplined soldiers, arrogant civil servants or overweening regents. Assertiveness, however, does not appear to be the president's strong suit. His handling of the delicate subject of radical Islam is a case in point.

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A model of tolerance

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Indonesia's large Muslim majority has traditionally been moderate. But will it stay that way?

Corbis

Keep it non-violent

IF YOU are trying to get to grips with Indonesian Islam, the village of Lingsar on the island of Lombok is a good place to start. On the outskirts of the village stands a leafy religious compound consisting of three adjacent courtyards. The one in the middle houses a shrine sacred not only to the Wetu Telu, followers of Lombok's traditional brand of Islam, but also to the island's tiny Christian and Buddhist communities. The one on the left contains a Hindu temple, maintained by immigrants from the neighbouring island of Bali, who account for a fifth of Lombok's population. In the third courtyard, devotees of all four religions wash side by side in a fountain fed by four streams of holy water.

The Muslim section of the compound bears no resemblance to a mosque. It is not aligned towards Mecca, has no minaret to summon the faithful to prayer, nor any space for them to pray. Instead, pilgrims make offering to sacred stones from Mount Rinjani, the volcano that dominates the island. The main difference between the rituals of local Hindus and Muslims, a guide helpfully explains, lies in the offerings they leave for the spirits of the rocks: Muslims tend to place incense and betel nuts on banana leaves, whereas Hindus wrap their gifts of rice and flowers in palm fronds.

The scene would horrify most orthodox Muslims, who abjure votive offerings, idolatry and above all spirit-worship, with its connotation of polytheism. What is more, complain doctrinaire locals, the Wetu Telu hold boozy parties to celebrate the prophet's birthday, despite Islam's strictures against alcohol, and their mosques have such low ceilings that they cannot stand up during prayers. Indeed, the very name Wetu Telu, which means “three times” in the local Sasak language—a reference to the number of daily prayers—highlights the sect's divergence from mainstream “five times” Islam.

This haphazard blend of animist and Muslim rituals is typical of traditional Indonesian Islam. The royal courts of Java used to leaven their Islamic beliefs with hefty doses of Hindu astrology and local folk religion. To this day, the Sultan of Yogyakarta, although a devout Muslim, offers hair and toenail clippings to the spirit of a nearby volcano. Many humbler Indonesian Muslims consult *dukun*, something between a faith healer and a shaman, about everything from colicky babies to troubled investments.

The Wetu Telu are also typical of traditional Indonesian Muslims in another sense: their numbers are dwindling. In the distant past, they were probably in the majority on Lombok. Now they have shrunk to a tiny sect, with perhaps 10,000 followers, whereas the ranks of more orthodox Muslims have swelled into the millions. A similar, if not quite so drastic, process is under way throughout Indonesia. Sects espousing Koranic literalism have spread like wildfire, especially at Indonesia's universities. Public displays of piety, such as going on pilgrimage to Mecca, or women wearing headscarves, are on the increase. Islamic publishing and broadcasting have become booming businesses.

This trend has several different causes. Improved communications with the outside world have made Indonesia's traditional Muslims more conscious of their peculiarity. Increasing urbanisation has cut off many of them from the customs of their birthplace. As education has spread, so has the tendency to dismiss folk religion as primitive superstition. Some academics cite the Iranian revolution of 1979, which helped to popularise a more puritanical form of Islam. Others argue that the sense of dislocation brought on by the rapid economic growth of the 1980s and 1990s prompted more people to embrace the comforting certainties of religion. By that logic, the upheaval following Mr Suharto's fall accelerated the trend further.

Proselytising has also played a part. Abdul Muhiet el-Lefaky, a former civil servant on Lombok, prides himself on having converted many Wetu Telu to mainstream Islam. Muhammadiyah, the organisation in whose name he preaches, was founded in 1912 to purge Indonesian Islam of pagan elements. It funds an Islamic boarding school near the biggest Wetu Telu village, in the hope of prompting more conversions. Muhammadiyah's 20m members mount similar campaigns throughout Indonesia. So, too, do more radical groups that try to spread fundamentalist strains of Islam, often financed by donations from the Gulf countries.

Defenders of the faith

At its extreme end, this campaign to defend and purify the faith shades into intolerance, intimidation and violence. In Lombok in 2002, a puritanical mob burned down the mosque of another minority sect they considered heretical. In other parts of the country, Muslim vigilantes sometimes ransack bars and brothels. In provinces with large Christian populations, such as Maluku and Central Sulawesi, radical Muslims have taken up arms to fight the supposed persecution of their co-religionists. The worst extremists have resorted to terrorist attacks against western targets in the name of Islam.

Nonetheless, it is important to keep the problem in perspective. Some 190m out of 220m Indonesians identify themselves as Muslim. Only a tiny proportion of these hold radical views, and only a few thousand have resorted to violence. In Java, according to a recent United Nations study, violent religious clashes most commonly occur not between Christians and Muslims, nor between traditional and orthodox Muslims, but among traditional Muslims who suspect one another of practising black magic. The vast majority, however devout, remain remarkably tolerant. On Lombok, during Ramadan, Balinese restaurants are free to serve up hearty lunches of roast pork in front of fasting Muslims. Alcohol is widely available. Veiled and unveiled women walk down the street hand in hand. Even Mr el-Lefaky, the missionary, shows an open-minded streak: Wetu Telu traditions should be preserved, he says, but as a cultural heritage, not a religion.

Indonesia does not have an official religion, although belief in God is enshrined in the constitution. Throughout the country, many Christians and Hindus hold senior posts in the army, the bureaucracy and business. Good Friday, Chinese New Year, Nyepi (a Balinese festival) and Waisak (a Buddhist one) are all public holidays. The viewers of the local version of “Pop Idol”, a hugely popular television talent contest in which the public picks the winner, recently awarded top honours to a Christian woman who began her singing career in a church choir. Nahdlatul Ulama, an organisation sympathetic to traditional Muslims, claims 10m more adherents than Muhammadiyah.

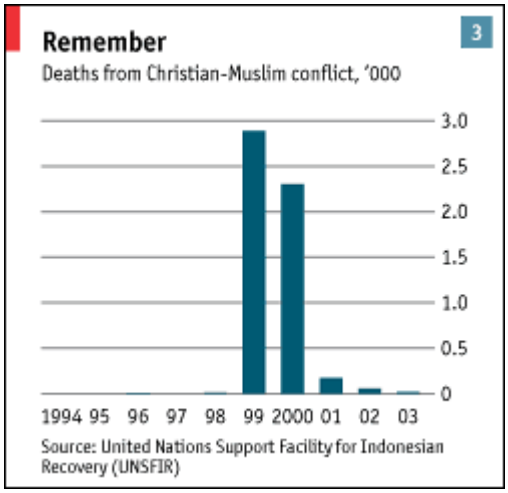
Politically, too, Indonesian Muslims remain steadfastly moderate. The proportion of Indonesians voting for Islam-inspired parties has actually fallen, from 45% in the 1950s to roughly 35% today. Back then, all the big Muslim parties supported the institution of *sharia* law; now none of them does. Most of them welcome non-Muslim members, and all preach the virtues of pluralism. Support for the fastest-growing Muslim outfit, the Prosperous Justice Party, took off only when it toned down its religious rhetoric and began to emphasise honesty and clean government instead. All six of Indonesia's presidents have been moderate Muslims—including Miss Megawati, an unveiled woman.

The increasing religiosity of many Indonesian Muslims is not a problem in itself. After all, many other countries, including America, have undergone religious revivals without descending into violence. The process of Islamisation has arguably gone further in neighbouring Malaysia, which remains perfectly peaceful. What is different about Indonesia is not the prevalence of radical views, but the ineffectiveness of the authorities in preventing extremists from putting their ideas into practice.

That is slowly changing. Large-scale religious violence appears to be on the wane (see chart 3), and most of it is confined to three remote provinces: Maluku, North Maluku and Central Sulawesi. The threat of terrorism, too, seems to be receding. At any rate, Jemaah Islamiah, the group thought to be responsible for most of Indonesia's recent bombings, is becoming less effective. Its attack in Bali in 2002 claimed some 200 lives. But the two subsequent blasts attributed to the group, near the Marriott hotel and the Australian embassy in Jakarta, killed far fewer, thanks largely to increased security.

Sidney Jones, of the International Crisis Group, says the police are

getting much better at tracking down suspects and tracing their accomplices. After the Bali bombing, one western diplomat explains, Australian advisers had to guide the Indonesian police through each step of the investigation. By the time of the embassy blast, the Indonesians themselves were ready to take charge. Hundreds of suspects have been arrested, and many of them tried and jailed.



Further atrocities seem inevitable, however, because Jemaah Islamiah's alleged bomb-makers, Azahari Husin and Noordin Muhammad Top, remain at large. Members of the group captured by the police claim it has recruited several willing suicide bombers. As Miss Jones puts it, “Every time they arrest someone, you realise the network is bigger than you thought.” Indonesia's enormous size and porous borders make the task of the police more difficult.

On the other hand, there are clear signs of a popular backlash against extremism. After the Bali bombing, many people seemed to believe that foreigners were orchestrating terrorism in Indonesia to discredit Islam, but that belief has fizzled out. Mainstream Muslim leaders promptly and strongly condemn terrorism and mob violence whenever it occurs. Various radical groups, including the Laskar Jihad militia, which helped to encourage fighting in Central Sulawesi and Maluku, claim to have disbanded. Others, such as the Indonesian Mujahidin Council, have seen their support dwindle. On one occasion earlier this year, when vigilantes from the Islam Defenders Front tried to raid a restaurant serving alcohol during Ramadan, angry locals pelted them with stones.

Pressure groups with names such as the Centre for Moderate Muslims and the Centre for Islam and Pluralism are springing up to challenge the radicals' narrow interpretation of Islam. Ulil Abshar Abdalla, the head of the Liberal Islam Network, is getting a lot of exposure in the media. A government committee recently cheered up liberal Muslims by proposing to outlaw polygamy, among other revisions to Muslim family law.

At the moment, however, the authorities are doing little to strengthen these moderate voices and discourage extremists. Faced with conservative outrage, the government has shelved the polygamy ban. The police, too, seem to shrink away from confrontation. During Ramadan this year, they admitted that they had advance knowledge of vigilante raids on several nightspots, but did nothing to prevent them. Cynics suggest that these thugs are in cahoots with the authorities in lucrative protection rackets.

Mr Yudhoyono himself can be worryingly reticent. As the top security minister in Miss Megawati's government, he failed to stop would-be martyrs from travelling to conflict zones to wage holy war. He has prevaricated about officially banning Jemaah Islamiah, which would make it easier to prosecute its members. And his new cabinet includes two ministers from the Crescent Star Party, a shrill and chauvinist Muslim movement.

Indeed, most Indonesian politicians seem uncertain where to draw the line between legitimate debate and unacceptable incitement. That may be partly because both Islamic and Indonesian culture attach great importance to harmony and consensus. The memory of Mr Suharto's brutal suppression of Muslim activism also makes today's politicians more reluctant to take a hard line. But the biggest factor may be plain inexperience. Indonesia is so new to democracy, and its institutions have undergone such upheaval, that politics is still in a state of flux.

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Suck it and see

Dec 9th 2004
From The Economist print edition

Indonesia's political institutions are so new that no one is sure how they are meant to work

Watch out for the fine print

EARLIER this year, Miss Megawati's government and parliament got into a fight over a proposed free-trade zone on Batam island. The cabinet had a design of its own for the zone, but parliament made big changes to it. Enraged ministers flatly refused to implement the new law, declaring it impractical. Livid parliamentarians accused the government of wilfully undermining the constitution.

Into this fray stepped Jimly Asshiddiqie, the head of Indonesia's year-old Constitutional Court. He suggested to Rini Suwandi, then minister of trade, that the government bring its complaint to the court. The idea, he says, did not seem to have occurred to Miss Rini.

Indonesia's political institutions have changed dramatically in the past five years—so much so that most Indonesian officials are still trying to discover how the new set-up is supposed to work. The original constitution, drawn up in 1945, had only 71 clauses. Since 1999, a series of amendments has expanded it to 199 clauses. Confusion is inevitable. Mr Asshiddiqie points out that there are roughly 50 inconsistencies within the constitution itself. One article, for example, proclaims unrestricted freedom of speech; the next suggests it can be curtailed. Indonesia's vast array of lesser laws, decrees and official instructions doubtless contain many more ambiguous provisions.

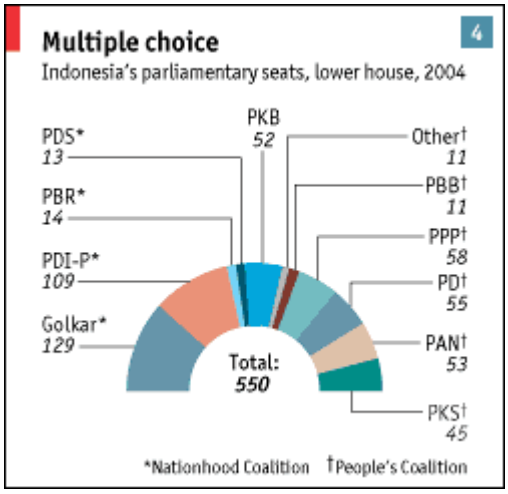
Conflict is also likely. Under Mr Suharto, supreme power rested with parliament in theory and with the president in practice. Now it is shared between the president, parliament, the judiciary and various independent agencies. Creating a working relationship between these different branches of government will involve a lot of trial, error and anger.

The Constitutional Court has already crossed swords with the government over its attempt to apply tough new counter-terrorism laws retroactively. The government, for its part, is trying to find ways to get around the judiciary. Even the two houses of parliament have been at loggerheads, over how to manage joint sessions.

If independent institutions such as the Constitutional Court and the Corruption Eradication Commission take an expansive view of their powers, such disputes will multiply. The vague mandate of the new upper house of parliament, which consists of non-partisan regional representatives, is also a recipe for strife. The constitution merely says it should participate in framing and overseeing laws related to regional autonomy. But it does not define regional issues, or explain what weight the chamber's decisions will carry.

The biggest question-mark hangs over relations between the president and parliament. Mr Yudhoyono's Democrat Party (PD) holds only 55 out of 550 seats in the lower house (see chart 4). Add in the two other parties that formally supported Mr Yudhoyono's presidential bid, Prosperous Justice (PKS) and Crescent Star (PBB), and the total rises to 111. A looser grouping called the People's Coalition, which will probably support the president most of the time, commands 233 seats. But the Nationhood Coalition, of parties that supported the election bid of his rival, Miss Megawati, still holds a bigger share of seats in the

house, and has vowed to remain in opposition.



Forget ideology

The president's advisers say that the moral authority bestowed by his popular mandate should help bring parliament into line. But his election victory is the cause of the problem, not the solution. The leaders of Golkar and PDI-P, the mainstays of the Nationhood Coalition, do not have any ideological quarrels with the president. They are simply bitter that an upstart politician from a tiny party has deprived them of the presidency, and are determined to cut him down to size. They have already secured the speaker's chair, and tried to exclude the president's allies from all committee chairmanships—a move that prompted the other parties to walk out, bringing proceedings to a standstill. They have also been resisting the president's choice for army chief. All this bickering has prevented parliament from getting anything much done so far.

Things might eventually become easier for Mr Yudhoyono if Golkar's leadership changes at a party congress later this month. Many of its members would prefer to switch to the president's camp, if only to benefit from the patronage he can bestow. Indeed, he has already tried to mollify the party by appointing two of its members to the cabinet. But whoever winds up in charge, Golkar, as the biggest party in parliament, will still be able to hold the president's initiatives to ransom.

In general, politics in Indonesia hinges less on ideology than on the accumulation and preservation of money and power. In one sense that makes the president's job easier, because he should be able to push any given measure through parliament so long as he offers the right inducements. On the other hand, it means that the leaders of big parties will always be looking out to advance their own influence, often at the expense of the president, not to mention the public interest.

Take the electoral system. Despite all the talk of Indonesia's model democracy, the big parties managed to slip some patently undemocratic rules into the fine print. For starters, independents cannot run for parliament. All candidates must be nominated by parties, and all parties must prove that they have a nationwide network of members and offices before they can make any nominations. If a party fails to win at least 3% of the vote, it will be excluded from future elections. All these rules make it hideously difficult for new parties to break the electoral oligopoly of the existing ones.

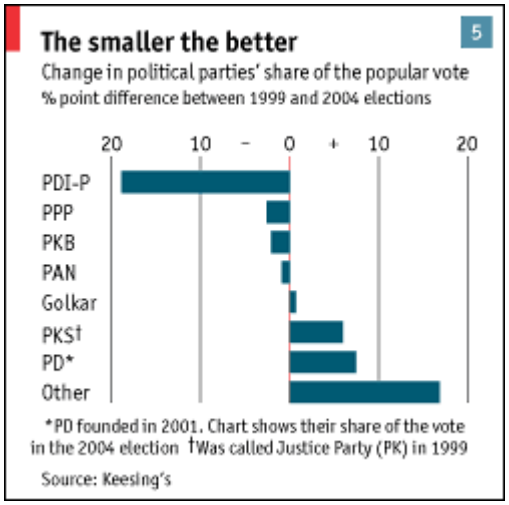
In the polling booth, voters must choose a party rather than an individual. Party leaders draw up lists of candidates for each of the multi-member districts. After an election, officials determine how many seats each party has won, and award them to that party's candidates in the order in which their names appear on the leaders' lists. To get elected, therefore, candidates need to be popular with the party leadership, not with the voters.

Voters do have the option of casting a second ballot, for a specific candidate from the list of their chosen party. In theory, this should allow local favourites to vault up the rankings. But to secure a higher slot on the party list, candidates must win an impossibly large share of these second ballots. In this year's legislative elections, only two people out of tens of thousands of candidates won a seat in their own right.

Allowing voters to select specific candidates in this way may actually strengthen the hand of party leaders. They cynically pad the bottom of their lists with celebrities, knowing that these will attract votes but will not get elected. If all else fails, party leaders can sack MPs at will and replace them with other, more pliant names from the party list. Earlier this year, several Golkar MPs who challenged the party's decision to back Miss Megawati, for example, found themselves out of both the party and parliament.

As if these measures did not concentrate power enough, the big parties are also trying to make sure they never lose the presidency again. Starting from the next election, candidates will need to be nominated by at least 15% of the members of the lower house. Had that rule been in place this year, Mr Yudhoyono might not have got the job. When direct elections for provincial governors and regents begin next year, candidates will have to meet a similar threshold of 15% support in the local assembly. That will give Golkar a massive head start in all local races, according to the calculations of the Centre for Electoral Reform, a local NGO.

These rules did not prevent voters in April's legislative elections drifting away from the established parties to newer, smaller ones, such as the Democrats and the Prosperous Justice Party (see chart 5). In total, more than a fifth of all voters appear to have shifted from one party to another. But the vast majority of Indonesians supported the same party as in 1999—a remarkable degree of loyalty, considering that all but three of Indonesia's parties are under six years old.



Most voters, it turns out, still abide by what anthropologists call "primordial loyalties" of religion, race, ethnicity and family. Rural voters in East Java continued to support the National Awakening party of Mr Wahid, the most famous local, despite his disastrous performance as president from 1999 to 2001. The people of Bali, in turn, threw their weight behind Miss Megawati, whose grandmother was Balinese. In Papua, whole districts went along with the choice of the local headman.

Moreover, many of those who switched parties do not count as swing voters in any meaningful sense. A leading light of the United Development Party, for example, broke ranks and set up a political vehicle of his own, taking many voters with him. So did various disillusioned luminaries from PDI-P. Even those voters who genuinely shifted allegiances tended to move to a party with a similar outlook: between secular nationalist parties such as PDI-P and the Democrats, say, or from National Mandate to the Islam-inspired Prosperous Justice Party (PKS).

All the same, the Indonesian electorate proved far more independent-minded in the presidential election than the elite in Jakarta had expected. Mr Yudhoyono romped home even though the country's two biggest parties, Golkar and PDI-P, had backed Miss Megawati. Most voters are also staunch centrists, points out Kevin Evans of the United Nations Development Programme. Radical parties, be they leftist, militarist or Islamist, got nowhere in the parliamentary polls.

Furthermore, argues Leo Suryadinata, of the Institute for South-East Asian Studies, popular disenchantment with the political establishment, although still muted, is likely to increase. Swing voters, according to the exit polls, were richer, better educated and more likely to live in a city. As people move away from the countryside, get more schooling and join the formal workforce, they may abandon their old political allegiances. Almost all voters have access to television, so they do get some exposure to alternative points of view. In the long run, that spells trouble for parties such as PDI-P, admits Kwik Kian Gie, one of its most prominent members.

Money and machinery helped to slow Golkar's decline, although voters will become disillusioned with the party over time, argues Marzuki Darusman, a dissident member. Mr Yudhoyono's charisma obviously boosted the Democrats. In the long run, however, there is no substitute for committed cadres, something only the Prosperous Justice Party appears to have in great numbers. Its reputation for probity, inspired by Islamic values, pulled in disgruntled voters in droves—including some Christians. It topped the legislative polls in Jakarta, and its leaders predict that it will soon become the country's biggest party.

The party's success hints at a growing disaffection among Indonesian voters. They will certainly be looking to Mr Yudhoyono to improve the economy and reduce corruption. But he does not have to work miracles. Most Indonesians feel that the government has done little or nothing to help them, so even small improvements would be greatly appreciated.

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So much to do

Dec 9th 2004
From The Economist print edition

But Mr Yudhoyono has a little time in hand to do it in

EPA

Hoping for the good life

ASK Indonesians what the government has done for them recently, and the answer is usually a laugh or a shrug. In the regency of Kediri, in Lombok, the principal of a state school complains that the money the authorities provide to cover the fees of the poorest students is not nearly sufficient. The local clinic, says one of its nurses, does not receive enough vitamins to hand out to pregnant mothers and children, as it is meant to do under a national health programme. There are government credit schemes to help poor farmers, but only the well-connected ever seem to benefit from them.

Many villages on the island have no road access, or electricity connection, or safe water supply. Nor is there any sign of improvement, villagers gripe. Things were better, they say, in Mr Suharto's day. It is much the same story throughout West Nusa Tenggara, which the United Nations Development Programme rates as the least developed province in Indonesia.

On the face of it, the new government has little room for manoeuvre to alleviate such dire want. It is already struggling to meet its deficit target this year, of 1.3% of GDP, and pressures on the budget are growing. Interest rates have just started to creep up from record lows, raising financing costs. In an expensive nationalist gesture, Miss Megawati declined further assistance from the International Monetary Fund last year. Most of Indonesia's loans come from foreign governments, and most of those consider an ongoing IMF programme a prerequisite for debt restructuring, so there is little hope of forbearance from the country's biggest creditors. Oil subsidies more than cancel out the windfall the government should be receiving from the current high oil price. Over the past few years, asset sales have helped to balance the books, but there is little of value left to sell.

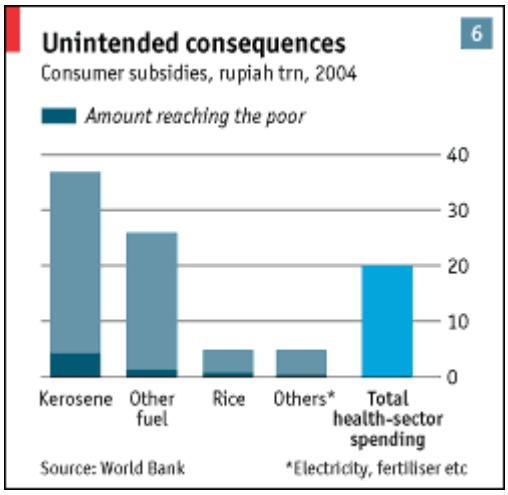
As bleak as all this sounds, there is some scope to raise revenue. Mr Kalla, the vice-president, has suggested that Indonesia could run higher deficits without sending the financial markets into a panic—although Mr Yudhoyono might first want to establish a reputation as a sound fiscal manager.

The government could certainly collect more tax. Only 2m Indonesians, less than 1% of the population, file personal tax returns. The head of the tax department recently estimated annual losses from evasion at 677 trillion rupiah. Indonesia's tax take, at less than 14% of GDP, is one of the lowest in the region. Kahlil Rowter, of Mandiri Sekuritas, an investment bank, reckons that a determined push could increase the government's haul by 0.5% of GDP every year for the next six years.

But the fastest and most obvious way for Mr Yudhoyono to free up money is by rationalising the government's current expenditure. This year, it is likely to fork out 63 trillion rupiah, or 3.5% of GDP, on fuel subsidies alone. These take the form of a blanket reduction in the retail price of kerosene and petrol, much of which is promptly smuggled to countries with higher fuel prices. The entire development budget runs to only 68 trillion rupiah.

The UNDP has calculated that the government could boost spending on basic health care and education throughout the country, distribute food to the poorest Indonesians, and increase the number of police while quadrupling their salaries, all for 50 trillion rupiah. In other words, the government could massively improve basic services, or double development spending, or completely eliminate the budget deficit and start paying down debt, just by phasing out fuel subsidies.

Mr Yudhoyono has resisted this for fear of hurting the poor, many of whom rely on cheap kerosene to cook. But only a tiny fraction of the fuel subsidy actually goes to people whom the government classifies as poor (see chart 6). The same is true of Indonesia's subsidised rice: only a quarter of the recipients are poor, according to the government's own findings. In fact, the government could reduce the cost of rice for all Indonesians without spending a penny if it lifted the ban on importing the stuff. This ban, which has driven the domestic rice price higher than the global one, has actually pushed 1.5m people into poverty, according to the World Bank.



Nor is that the only way in which Mr Yudhoyono could improve ordinary Indonesians' lives at no cost to the government. He could give farmers proper title to their land—something that only a quarter of them currently enjoy—and so enable them to use it as collateral for loans. He could raise rural incomes by allocating more of the money spent on road construction to farm-to-market roads. In general, he could filter more money directly to grass-roots development projects, bypassing Indonesia's corrupt and inefficient bureaucracy.

All the signs indicate that Mr Yudhoyono thinks far more deeply and creatively about these issues than Miss Megawati did. For a start, he comes from humbler origins. He reads and consults widely, with both foreigners and Indonesians. He took time out from electioneering to complete a doctoral thesis comparing the effects of development spending on rural and urban poverty. To defend it, he gave a PowerPoint presentation on his laptop—an extraordinary show of dynamism by Indonesian standards.

But Mr Yudhoyono also seems to want to be all things to all people. His cabinet contains an odd blend of generals and civilians, opposition politicians and allies, technocrats and hangers-on. All the policies he has enunciated so far are cautious to a fault. On fuel subsidies, for example, he has suggested raising the price of premium petrol only—and not until next year.

Be bold

Some argue that more radical or disruptive decisions will not go down well in Indonesia. After all, Abdurrahman Wahid, who during his time as president instituted all manner of bold reforms, lasted only two years in office. But that was back when parliament had the right to sack presidents on a whim. Now that right has passed to the voters, and they clearly indicated their displeasure with Miss Megawati's sedate pace of business earlier this year.

Mr Yudhoyono will doubtless find it difficult to square the popular desire for change with the recalcitrance of the political elite. Problems such as corruption, religious extremism and the tension between the centre and the regions will take more than a single presidential term to resolve. But the possibility that exasperated voters will throw him out in 2009 should act as a powerful incentive to get things moving. In that sense, Indonesia's still imperfect democracy is working like a charm.

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Fiat and General Motors

Divorce Italian-style

Dec 9th 2004 | TURIN
From The Economist print edition

Kobal

Is Fiat's marriage to General Motors coming to a bloody end?

IT PROMISES to be a classic piece of business theatre. On December 14th Sergio Marchionne, boss of Italy's troubled Fiat group (its fifth in two years), will fly to Zurich for a showdown with Rick Wagoner, boss of General Motors, and John Devine, GM's chief financial officer. The message Mr Marchionne will deliver is stark: if you want to be released from your legal obligation to buy the rest of Fiat Auto (and GM desperately wants out), it will cost—not just money, but a renegotiation of the entire partnership between the two carmakers, on terms more favourable to Fiat.

It could all end in tears. Fiat is sure to get a hostile reception. GM is struggling financially. Its European operations are a mess. It now regards Fiat as a basketcase, and regrets its ties to the Italian firm. The Detroit-based giant has already threatened to go to court if Fiat tries to make it honour its legal obligation to buy Fiat Auto—the “put option” it gave Fiat in 2000. GM may well regard Fiat's confident assertion that it would win in court as mere bluffing. GM will certainly deliver a stark message of its own: if we are forced to buy Fiat Auto, not much of it will survive once it has been restructured to be profitable. In other words, there would be thousands of job losses and a huge political storm in Italy that could blacken the name of the Agnellis, Fiat's big family shareholder, and dash the hopes of Fiat's chairman, Luca di Montezemolo, of one day succeeding Silvio Berlusconi as prime minister.

The put option was part of a deal whereby Fiat sold 20% of Fiat Auto to GM for $2.4 billion, taking a 6% share of the American carmaker in return. (Fiat has since sold its GM shares to raise cash, while GM has written its investment down to a mere $220m.) The price would be decided at the time of a sale by investment banks. Also included in the 2000 deal was an industrial alliance between Opel, GM's European subsidiary, and Fiat Auto.

Head-on collision

At the time GM feared that Fiat would be sold to rival DaimlerChrysler. Now Mr Wagoner's move looks less than smart. The partnership had a short honeymoon with a joint-venture to produce engines and gearboxes, and another for the purchase of car parts. There is also a plan to share the basic body

underpinnings for new Corsa and Punto models next year, if the two firms are still partners by then.

Instead, they may divorce or, if that proves simply too messy, opt at least for an open marriage. Under the chairmanship of the late Umberto Agnelli there was no question of trying to exercise the put option, for fear that a protracted legal battle would hurt Fiat. GM made clear to him that it thinks that changes at Fiat Auto have rendered the put option invalid, and it is prepared to assert that in court (in the Netherlands, where Fiat Auto's parent company is registered and Italian political pressures probably are not felt). GM was particularly irked by the sale in 2002 of Fidis, Fiat's finance arm, the sort of business car firms such as GM depend on for profits.

The current regime at Fiat is taking a harder line on the put option—not least because the Agnellis, having recapitalised Fiat once, are decidedly reluctant to sink any more money into Fiat Auto. Fiat's new bosses are adamant that the put is still enforceable and that, without a full merger, continuing the current relationship with GM makes no sense. “You can't be half pregnant,” says one Fiat director.

But Fiat's true agenda may be to provoke GM into paying a chunk of money to kill the put option, and to agree a looser alliance. The current one started to go wrong in early 2003. As Fiat's losses mounted, GM refused to stump up its share in a €5 billion ($5.6 billion) re-capitalisation of Fiat, and its stake halved to 10%. In October 2003 GM and Fiat agreed to postpone the start of the five-year period in which Fiat can exercise the put by one year to January 24th 2005. They also pledged to refrain from litigation until December 15th, the day after the showdown in Switzerland.

Fiat claims to have no interest in renewing that truce. GM now gets access to Fiat's excellent diesel engines without giving much in return, complains Fiat. Being with GM also stops Fiat hooking up with new partners. John Elkann, Fiat's vice-chairman, whose grandfather's grandfather founded the firm, says, for example, that an existing joint-venture with Peugeot to make people-carriers and small vans would not have been possible under the terms of the agreement with GM.

If Fiat's attempt to exercise the put option should fail, sorting out Fiat Auto will again become solely a domestic Italian problem. But even if it goes to court and wins, Fiat would prefer not to have a reluctant owner; instead, it would probably like to negotiate a price to let GM off the hook. Perhaps $1 billion would do the trick. The existing industrial joint-ventures between the firms would probably continue, but the grand alliance would be over.

That would not solve the problems of Fiat Auto, however. In 15 years its share of Europe's car market has nearly halved, to around 8%. The group lost €1.9 billion ($2.1 billion) last year, after net losses of €3.9 billion in 2002 and around €400m in 2001. Industry observers reckon it still has more than 30% over-capacity.

Fiat's brand is linked solely to small cars where margins are thin. But with a single model, BMW's Mini rivals Fiat's Alfa Romeo subsidiary, with its handful of models and strong brand. Fearing the worst, the mayor of Turin is already making contingency plans for mass layoffs at Mirafiori, a big Fiat factory, and nearby suppliers.

The fight between Fiat and GM is being watched with some dismay by the group of Italian banks that made Fiat group a €3 billion convertible loan in 2003. No one expects the loan to be repaid on time next September, after which the banks stand to own almost 30% of Fiat shares.

Fiat Auto has burned nearly €3 billion of cash this year, and the banks do not want a repeat in 2005. Yet that seems inevitable. Even if GM took over Fiat Auto, its losses would continue for some time. The banks are also thoroughly alarmed by reports (strongly denied by Fiat) of bickering over strategy between Mr Marchionne and Herbert Demel, boss of Fiat Auto and a former chairman of Audi.

Even so, the banks are reluctant to force the pace, for fear of being blamed if Fiat were suddenly to implode. They are still smarting from scandals at Cirio and Parmalat. The last thing they want is to be blamed for precipitating a fierce rationalisation of Fiat's car business. They also have huge loans outstanding to Fiat's myriad suppliers around Turin. Nor do they want to be seen to force a takeover of Fiat by the Americans. Unconstrained by concerns about political and social fallout in Italy, GM would not hesitate to impose a painful cure, as it has done at struggling Opel, where it is cutting up to 12,000 jobs.

Mr Marchionne has made few changes to his predecessor's recovery plan other than making its timetable for recovery a bit less over-optimistic. But the outlook remains dire. After all, he hopes only to break even at group operating level this year and to trim the car division's losses next year. Mr Marchionne

cites the recovery of France's Renault and PSA Peugeot Citroën in the mid-1990s as proof of what can happen. Fiat sees Peugeot as a role model. But it is in deeper trouble than Peugeot ever was. If nothing else, the showdown in Zurich will make that clear.

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Motor racing

Racing certainty

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Formula One faces more court battles and an uncertain future

EPA

Bernie's in the pits

BERNIE ECCLESTONE is a survivor, but it has been a bad week for the British entrepreneur who has run the commercial side of Formula One (F1) motor racing almost single-handedly for nearly 30 years. He must have been mortified to read headlines pronouncing that he had lost a court battle, to which, strictly speaking, he was not even party, for control of the sport.

The case was brought by three banks against Bambino Holdings, which owns 25% of the firms that exploit commercial rights to F1, and two Swiss lawyers who act for Mr Ecclestone's family trust, the ultimate owner of Bambino. (Counsel for Bambino emphasised the "separateness" between Mr Ecclestone and Bambino, which are not synonymous.)

The banks, which own 75% of the F1 firms, were challenging the validity of the appointment by Bambino in October 2002 of the two Swiss lawyers to the board of Formula One Holdings (FOH), the immediate shareholder of Formula One Administration (FOA), F1's key operating firm. The appointments left Bambino rather than the banks with board control of FOH. The judge saw no need for a full trial as Bambino had " no real prospect" of defending the banks' claim. This was unsurprising: in the absence of exceptional circumstances, no court is likely to sanction a shareholder with a 25% stake having more say than one with a 75% stake.

The banks now control FOH's board, but Bambino remains in charge of FOA, of which Mr Ecclestone is chief executive. In 2002, Bambino took board control of FOA, then changed its articles of association with the effect of cementing its position. This cannot be undone without Bambino's consent. The banks will have to challenge its validity in the courts. As with the first case, Bambino faces another loss.

Meanwhile Bambino and the banks face a threat that could make their shares worthless. Four of the carmakers (BMW, DaimlerChrysler, Ferrari and Renault) which back F1 are planning a rival series of races at the end of 2007, when the current contracts that govern the sport expire. To avert the breakaway, the banks and Bambino need to give the teams more of F1's revenues and, as importantly, the carmakers more say in running the sport. An outline deal, signed by all parties, including Mr Ecclestone and Bambino, was reached at the end of 2003 but fell apart.

Under the deal, Bambino was to cede board control to the banks and car firms. Mr Ecclestone would have appointees of the car firms and banks looking over his shoulder at FOA. The court battle raises the suspicion that the deal collapsed in part because neither Bambino nor Mr Ecclestone wanted to surrender any control.

With control of FOH, the only shareholder in FOA, the banks can now remove Mr Ecclestone as a director of the latter. But they would need Bambino's consent to reach a deal with the carmakers—board control of all the F1 firms would not be enough. Unless Bambino is ready to compromise, F1 may have no future.

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Chinese business

Champ or chump?

Dec 9th 2004 | HONG KONG
From The Economist print edition

What the IBM/Lenovo deal says about Chinese firms' overseas ambitions

IT SOUNDS like the testosterone-tinged vision of an investment banker: a little-known upstart buys its most famous rival, three times its size. Yet this time it happened in Beijing—on December 7th, when Lenovo, China's leading maker of personal computers with $3 billion in annual sales, bought the $9 billion-a-year PC division of mighty IBM for a puny $1.75 billion. The deal puts Lenovo into the industry's third place, behind Dell and Hewlett-Packard (HP).

Lenovo's move is the latest example of big Chinese firms aggressively expanding abroad, under orders from their government. Industrial firms such as PetroChina and Baosteel have been buying access to raw materials. TCL, an electronics group, won a controlling stake in a joint-venture with Thomson of France. Huawei, in telecoms equipment, and Haier, in white goods, are trying to build global brands. Liu Chuanzhi, Lenovo's co-founder and chairman, says that the IBM deal makes his group “a truly world-class company”.

In fact, cut-throat competition at home is at least as responsible for driving Chinese firms overseas as Beijing's grand vision. Lenovo, despite great connections, government contracts and a low tax rate (proof of official favour), is under pressure in China. Its market share, at 27%, is under attack. Its shares have fallen by 23% this year. “If we just focus on China, we cannot generate returns for our shareholders,” admits Mary Ma, Lenovo's finance chief.

Facing structural overcapacity and intense but unfair domestic competition from firms that often are kept from bankruptcy by officialdom, it is no wonder many leading firms are seeking their fortune abroad. But, expanding out of weakness not strength, the danger is they will buy bad assets. TCL, for example, ended up taking a loss-making business with a dog-eared brand (RCA) off Thomson's hands. The same could be true of Lenovo.

There is no arguing with the strength of IBM's brand, which Lenovo has the right to use for five years—quite a vote of confidence in the firm from Big Blue. But PCs have become commodities. Martin Gilliland of Gartner, a research firm, expects PC revenue growth to fall from 4% to 2% a year by 2007, and that three of the top 10 vendors will exit the market. IBM, which invented the PC in 1981, is no longer a technology leader like Apple, or a cost leader like Dell. The business Lenovo is buying has hovered around break-even for years.

It is unlikely that Lenovo can bring much by way of management skill or strategy to its target. The Chinese PC-maker has dithered strategically—first dropping its Legend name as part of an international growth drive, then selling non-core businesses and refocusing on rural domestic customers—before doing the IBM deal. Cost savings are limited to purchasing synergies, since IBM already manufactures in China and other low-wage countries. Lenovo seems unlikely to improve efficiency at IBM's operations—the Chinese firm's 15% gross margins in 2003 were below those of many domestic rivals and less than half of IBM's.

But Lenovo may make things worse, given cultural differences between Americans and Chinese, big differences in pay and the need for interpreters at every meeting. Vincent Yan, finance director of TCL, which is going through the same experience with the French, has admitted that the cultural gap proved wider than expected. The more disruptive the IBM acquisition proves for Lenovo, the better it will be for Dell, a true global champion.

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Patents

Scholars for dollars

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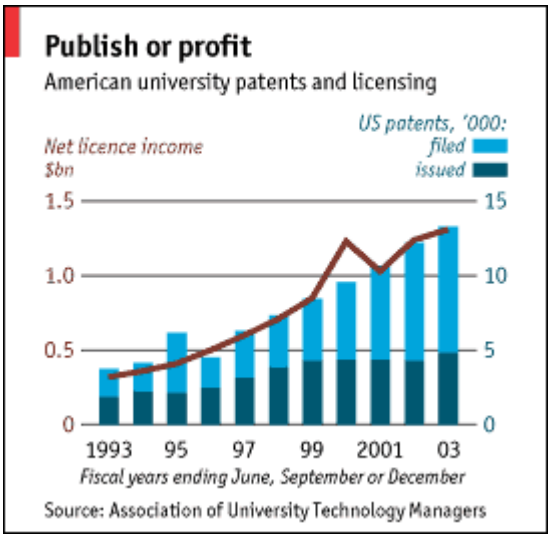
Are universities acting too much like businesses?

WHEN it comes to intellectual property, perhaps the ivory tower has had too much of a good thing. On December 6th, seven biotech firms and Columbia University in New York issued a report to an American court outlining the unresolved issues of a lawsuit over a patent held by Columbia that the firms consider invalid.

In a complicated legal tussle, many biotech companies—including Amgen and Genentech, America's two largest ones—had sued Columbia for seeking licensing fees on a patent issued in 2002 that is nearly identical to one that expired in 2000. The industry reckoned that the technology, covering "co-transformation", a process of introducing new DNA into a cell that is used to make many drugs, was thus in the public domain and free to use. Columbia's licences have earned it around $400m.

Amid much controversy, America's Patent Office decided to reassess the 2002 patent award, which the industry says is an obvious variant of the old one; Columbia argues it covers even more claims than were granted. With criticism mounting, in October Columbia promised not to sue the biotech firms. The court then decided not to rule on the legitimacy of the patent since the Patent Office is reviewing it and Columbia is not enforcing it. But in this week's filing, the biotech firms seek to keep the case alive; Amgen, for one, cites Columbia's "misconduct". Columbia says the charges should be dismissed.



This ugly spat highlights the growing concern that American universities are acting more like commercial firms than academic institutions. The 1980 Bayh-Dole act made it easier for universities to commercialise their research; in 2003, American universities earned $1.3 billion from patents (see chart). Many other countries have passed or are considering similar legislation to emulate America's university licensing system. The benefit is that it enables discoveries to get into the private sector quickly by giving universities a financial incentive.

But it exposes a conflict of interest: universities want to garner licensing revenue, yet rely on using other organisations' intellectual property for their research. Indeed, an American court ruling in 2002 against Duke University stated that universities cannot presume to be exempt from patent infringement under an "experimental use" exception for non-commercial research. This is because the activity furthers universities' "legitimate business objectives...to increase the status of the institution."

This has cast a shadow over the validity of the “experimental use” exemption for all universities. Many are now lobbying Congress to enshrine it in law. Their argument is not helped by the aggressiveness with which Columbia and others among them have pursued their patent rights.

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Protectionism in America

The wine war

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Seven decades after Prohibition, America still bickers over booze

DAVID LUCAS, who beams with pride at the “fruity zinfandel almost like a pinot” that he grows at his tiny winery in California, is totally shut out from America's second-largest wine market, the state of New York. There are, of course, New York tourists who occasionally drop by for a tasting. But they soon discover that New York laws do not allow them to order a case from Mr Lucas to be shipped home. That is because New York is one of 24 American states that ban or restrict direct wine sales from other states. Selling through New York's huge wine wholesalers is also not an option, since the Lucas Winery is so small that the wholesalers will not do business with it.

A few years ago, Mr Lucas got together with a grower in Virginia and three consumers in New York and sued the state and its big wine wholesalers. Michigan and Florida had similar cases. This week, the dispute went to America's Supreme Court.

Coincidentally, this was the same week, in 1933, that America ended its 15-year experiment with teetotalling by passing the 21st amendment—and so laid the foundation for today's mess. The amendment not only repealed Prohibition but also gave the states the right to regulate alcohol. The constitution seems to pit free trade among the states—guaranteed in its commerce clause—against states' rights.

Kenneth Starr, the lawyer-tormentor of Bill Clinton over his affair with Monica Lewinsky, now advises some of the growers. He argues that the amendment should be understood in its proper context. America was not exactly a landscape dotted with vineyards in 1933. Legislators probably pictured bourbon-swilling drunks as they cast their votes. Today, wine is a $20 billion industry in America. The country now has more than 2,500 growers, some in every state. Stopping them selling across state lines robs consumers and growers of a fundamental freedom, says Mr Starr (adding that he himself is no connoisseur), and is simply state protectionism.

Nonsense, says Randy Mastro, a lawyer representing New York's wholesalers. The constitution is sacred, he says, and “the amendment has very plain language” stating that alcohol is a unique product which the states can regulate as they please.

Besides, distributing out-of-state wines through licensed wholesalers—as New York requires—keeps it away from minors, says Mr Mastro. It ensures that excise taxes are collected. Besides, wineries from other states are free to get a New York licence and set up shop there for “a couple of thousand dollars a year”. Mr Lucas finds this laughable. “This is not about sending ten cases of wine to New York,” he says. “It's about staying in business. $1,000 for a licence is a lot of money to a small winery.”

Mr Starr calls the wholesalers' arguments “smokescreens” for their greed. If New York truly thought that direct sales led to more under-age drinking, the state would ban all of them. But New York only bans out-of-state direct sales. Why not simply require shippers to get an adult's signature when they drop off a case? And nobody seems too bothered about tax on other goods bought online, at Amazon or wherever, and shipped across state lines.

So the wholesalers “have behaved in a rather shabby way,” says Mr Starr. “They say ‘deal only through us, but by the way, we will not deal with you because you are too small’.” He says this is really about the 20% or so that the distributors mark up on every bottle. Mr Lucas adds a broader historical perspective. “I blame this all on the English,” he tells *The Economist*. “You sent us a boatload of Pilgrims. Just think if the Mayflower had been full of Italians.”

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Law firms

The bigger the better?

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The merger between DLA and Piper Rudnick creates a new global giant

ONE of Britain's mid-market stars, DLA, is to join up with Piper Rudnick, a medium-sized American firm, to form what will be the world's third-biggest law firm in terms of both lawyers—2,700—and revenue based on returns for the first half of 2004. Next year, it hopes to grab the number two slot by revenue, with a projected turnover of $1.5 billion. It will be the only firm with more than 1,000 lawyers on each side of the Atlantic.

Too confident? Some would say so, seeing how Clifford Chance is still struggling nearly five years after its marriage to New York's Rogers & Wells in 2000. Although still the world's number one by lawyers and revenue, London's “magic-circle” firm has lost 84 partners in the past year (out of a current total of 582), half in America—including many of its star “rain-makers”. Over the past five years, 271 partners have left, including 80 in America.

Clifford Chance's “lockstep” system of remuneration, espoused by most English firms, seems to have been the main stumbling block to a happier union. Under this, profits are shared among partners according to a sliding scale of seniority. But like most American firms, Rogers & Wells was used to an “eat-what-you-kill” system by which profits are shared according to how much business each partner brings in.

Hoping to keep its American partners happy, Clifford Chance cobbled together what was supposed to be a short-term compromise allowing stars in its main American offices to be paid above the top lockstep rate. But with a top lockstep rate for the past fiscal year of under $1m, compared with over $3m that is paid to top rain-makers by some American firms, Clifford Chance has struggled to compete. Meanwhile, the compromise continues—irritating the firm's English partners.

DLA, Piper Rudnick and Gray Cary, a small Silicon Valley firm that joined forces with Piper Rudnick two months ago, hope to avoid at least this problem, all having similar merit-based compensation. But for all their careful preparations—they say their marriage was two years in the making—there are bound to be other sources of tension, not least over differences in culture. This has been the cause of many an aborted union over the past few years.

Three other British magic-circle firms—Linklaters, Allen & Overy and Freshfields Bruckhaus Deringer—have contemplated similar moves, but failed to find a suitable American partner. New York's top firms, most of them small and hugely profitable, are evidently happier continuing to exploit the world's biggest and richest legal market on their own.

But lesser-known firms, particularly in America, are increasingly exploring the possibility of foreign mergers in order to establish global reach. Like DLA and Piper Rudnick, they reckon that, as their corporate clients become increasingly active across national borders, they will prefer to deal with a single law firm that can offer them a broad range of legal services locally, nationally and internationally. So despite the pain, more attempts at cross-border mergers by law firms are probably on the way.

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Executive pay

CEOs and their Indian rope trick

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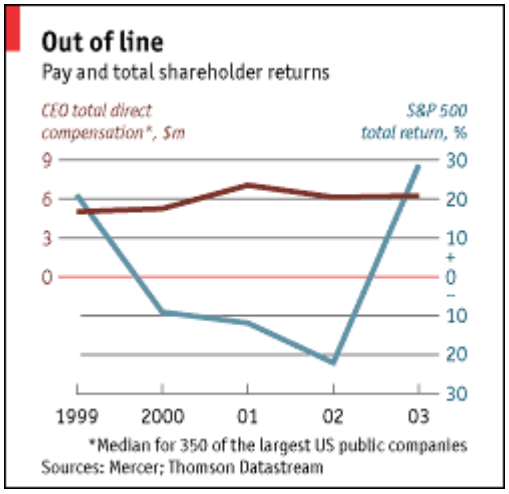
The link between pay and performance is weak



EXECUTIVE pay should reflect performance, right? But does it? A recent survey by the Hay Group, a consultancy, puts the average basic annual salary of the chief executive of a large American firm at $1m. But his total remuneration is more like $5m. Some of the extra comes in perks, but most is “variable pay”—bonuses and stock options that supposedly relate to the performance of his firm. That high level of variable pay should lead to sizeable fluctuations in total remuneration, as good years follow bad, and vice-versa. Yet for a while there has been little sign of that.

Performance-related pay is meant to align executives' rewards with those of shareholders. And indeed top executives' remuneration spiralled up, with the stockmarket as a whole, in the boom years at the end of the 1990s. But it continued to levitate thereafter, like the subject of an Indian rope trick. Mercer, a consultancy, says that the median compensation of bosses of big American firms (a different sample from Hay's) rose from $5.2m in 2000 to over $7m in 2001, a year when tumbling share prices cut shareholders' assets by some 12%. (Though, to be fair, performance pay is often paid after some delay, so a close correlation between pay and share price in any given year would be surprising.)

The differential between the pay of top executives and their workers has grown. In 1991 the pay of the average American large-company boss was about 140 times that of the average worker; by last year, it was over 500 times, and growing. Last year's 7.2% rise in the average American boss's total compensation is worth over $400,000—nice work, if you can get it.

In aggregate, the sums forked out in pay to top American executives are now enormous. According to Lucian Bebchuk of the Harvard Law School and Cornell's Yaniv Grinstein, the top five executives of 1,500 large American companies in 1993-2002 received a total of about $250 billion.

The Hay Group reckons that a European chief executive's basic salary is much the same as that of his counterpart across the Atlantic. But variable pay adds only 150% to that, as against 400% in America. And far more of the European's package is in bonuses and free shares linked to the performance of the company relative to its sector or an index, rather than in options which relate rewards solely to the movement of the company's share price.

Will American practices spread worldwide? Watson Wyatt, an employee-benefits consultancy, says that American multinationals increasingly are applying a common compensation scheme to all their operations. But Mark Reid, the head of Towers Perrin's UK compensation practice, says that investors in British companies have recently become far more involved in setting executives' pay and are opposed to the globalisation of American norms. The chairman of a big British company's remuneration committee now talks with its 10-15 biggest investors about top-level pay regularly, once or twice a year. “The degree of dialogue has changed enormously,” says Mr Reid.

Levels of disclosure in Europe too are improving—often from next to nothing. Last month the European Commission recommended that, each year, firms release a breakdown of all the components of their directors' fixed and variable pay. It urged European countries to take suitable measures by the end of June 2006—measures already established in Britain and being gradually adopted in Germany.

Germany's Cromme Commission recommended last year that firms publish details of the remuneration of individual board members. To date, they have only been required to release aggregate figures. So far nine out of the 30 companies on the German stockmarket's DAX index have complied. DaimlerChrysler and Porsche say they will hold out for non-disclosure, but the government has threatened to enforce disclosure by law if companies do not do it voluntarily.

The issue is now at the forefront of the corporate-governance agenda. In November, CalPERS, America's largest public pension fund, vowed to hold “directors and compensation committees more accountable for their actions.” (Its president was forced out soon after.) Last week William Donaldson, the chairman of the Securities and Exchange Commission, told compensation committees to focus more on performance-related pay schemes.

The likely introduction of accounting rules that will compel American companies next year (for the first time) to “expense” share options—ie, measure and take into account their cost—will reduce their attraction. That prospect has already persuaded companies such as Microsoft, Cisco Systems and Hewlett-Packard to change the assumptions underlying their option schemes in order to reduce their potential impact on the bottom line.

The new rules should not, however, deter companies from trying harder to design compensation schemes that more closely align actual pay with actual performance. Huge pay packets for bosses would be much less controversial if there was evidence they had actually earned them.

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Europe's energy markets

Monopoly? It all depends whose

Dec 9th 2004
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The EU has one rule for big countries, another for small, claims Portugal

Reuters

Home-made hot air

NATIONAL monopoly? *Mais non*, that's our national champion, quite a different thing. Such is the argument used for years by successive French governments to defend Electricité de France (EDF), their state-owned electricity outfit, against foreign intruders and Europe's antitrust meddlers. Today it is the Portuguese who wheel it out, to let their private-sector, yet all but monopoly electricity firm, Energias de Portugal (EDP), take control of state-owned Gás de Portugal. We need a group large enough to compete in next year's Iberian common market in energy, they say. But France is a big country, Portugal a small one, and the EU's competition watchdog—backed on December 9th by the EU Commission—has firmly growled “No”.

The Portuguese feel hard done by. In 2001, E.ON, Germany's biggest electricity company, and sizeable in gas too, wanted to get hold of Ruhrgas, master of nearly all the rest of that country's gas. Germany's anti-cartel office, its monopolies commission and its consumer-affairs ministry were all hostile. But the economics ministry wanted a national champion in energy (to be exact, a second one, since it already had RWE) and it had the last word. And the EU's competition watchdog? It found reasons in its rule-book to look firmly the other way. Germany too is a big country.

Yet, fair or unfair, the EU is right about EDP. In theory, next year Spain and Portugal will indeed start to become a single energy market. Not so in fact. Portugal allows competition already, and EDP—once state-owned, now 80% private—may truly believe in it: the firm has just raised $1.6 billion to buy control of HidroCantábrico, number four in Spanish electricity. But physical and other constraints mean that a real Iberian energy market may be years away. And such a market, as Álvaro Barreto, Portugal's economy minister, said this week, is the “only” road to real competition in gas and electricity in his country.

Facing an EU ban—and a likely change of government at home—he has put the plan on hold. So will the EU now get a grip on larger monopolists? Don't count on it. It pussyfooted for years as the French, defying its directives, kept their energy market all but closed, while state-backed EDF ran around Europe buying up smaller companies, or stakes in them, in Britain, Germany and Italy. The EU has since prised the French market slightly open, but not for residential customers, and EDF still holds 90%. And the huge share issue that EDF now plans—up to 30% of its equity, raising up to €11 billion ($14.75 billion)—will do less than nothing to open up markets. EDF, still 70% in state hands, will just have more cash to defend its own turf while extending its hold on other people's.

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Face value

The case of the poison pill

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Will Leo Strine re-engineer takeover law in America?

BY SUING PeopleSoft over how the software firm has been fending off its hostile bid, Oracle, a big rival, has given America a rare opportunity to rethink the law governing takeovers. That task will fall to the Court of Chancery in Delaware, the state where most big American firms are incorporated, and in particular to Leo Strine, one of the court's four vice-chancellors. Personable, witty and erudite, Mr Strine has blazed a reputation in his six years as a Delaware judge, both as an intellectual dynamo and as a man who does not shrink from putting his stamp on the law. Earlier this year, he shredded the reputation of Conrad Black with a forcefully worded 130-page ruling blocking Lord Black's sale of his stake in Hollinger Inc, a holding company that owned (among other newspapers) Britain's *Daily Telegraph*. The “evasive and unreliable” Lord Black, thundered Mr Strine, had “breached his fiduciary and his contractual duties persistently and seriously” in his behaviour towards Hollinger Inc's American subsidiary, Hollinger International. The Canadian newspaper magnate has never looked like recovering from the drubbing.

Oracle's suit alleges that PeopleSoft has abused its takeover defences to entrench incumbent managers and directors at the expense of the firm's shareholders. PeopleSoft has done this in two ways, argues Oracle. It has set up a “customer-assurance programme”, guaranteeing cash payouts of between two and five times PeopleSoft's software-licence fee if support for that software is cut off. It has also put in place a “poison pill”, which would flood the market with new PeopleSoft shares if a predator buys more than one-fifth of the firm's equity. Last month, more than 60% of PeopleSoft's shareholders voted to accept Oracle's most recent offer of $24 a share—a healthy premium to PeopleSoft's share price at the time. PeopleSoft's directors spurned the bid, arguing that most of the shareholders continue to believe that the firm is more valuable. Mr Strine will hear more evidence on December 13th, and give his ruling within a few weeks.

Mr Strine will be stepping on remarkably unsettled ground. Mostly, the statutes that govern Delaware's system of corporate law openly delegate decision-making authority to company directors. Oddly, Delaware's legislature has remained studiously silent about what should happen during takeovers. As a result, there has been much debate among lawyers, who have now divided into two competing schools of thought. The first wants to leave it to shareholders to choose when, and at what price, a firm sells itself to a hostile bidder. The second prefers to leave this decision to company directors, who are elected by shareholders to run a firm on their behalf. The second school embraces poison pills and other defensive devices as a way to protect the primacy of the board's authority during takeovers; the first school scorns them as a diabolical way to thwart the will of shareholders.

Deprived of legislative guidance, Delaware's courts have struck an uncertain compromise between the two schools. They have let boards put up defences such as poison pills to ward off hostile attacks. Yet, acknowledging that boards might abuse these defences to entrench themselves, Delaware reserves for itself the right to police takeover defences for their “reasonableness”. This reasonableness test has appeared, over the years, to give ever more deference to the judgment of the board. Famously, in 1989, Delaware's Supreme Court said that Time's directors could “just say no” to a $200-per-share hostile bid from Paramount, forcing shareholders to accept a $138-per-share friendly bid from Warner instead. In a 1995 ruling involving Unitrin, an insurer, Delaware appeared to reserve to itself the right to strike down takeover defences only if they were “draconian”.

Mr Strine's instincts clearly bend towards greater shareholder choice. Writing in the *Stanford Law Review* in 2002, he said that Delaware had in fact ducked the issue of whether directors could just say no to a hostile bid, and that its courts should confront the boundaries of directorial discretion directly. Law professors (most of whom want greater shareholder choice) and shareholder activists tend to embrace Mr Strine as a fellow “reformer”. Corporate lawyers, who are closer to the interests of directors, like to paint him as a bit of a maverick. America's corporate scandals and the sense that boards have done a bad job and deserve no deference have created a favourable climate for change. Does the Oracle suit deal Mr Strine a winning hand?

Will Leo roar?

PeopleSoft's customer-assurance programme certainly placed questionably tough restrictions on a hostile bidder's freedom of action. PeopleSoft's board was notably aggressive in the way it cited a Department of Justice antitrust lawsuit against a merger of the two firms (which Oracle later defeated) as a reason for refusing to negotiate with Oracle. From time to time, PeopleSoft's senior managers have made noises suggesting that they are unwilling to negotiate with Oracle at any price.

But if he is to strike down the poison pill, Mr Strine will probably need to string together a narrative of a company that openly and persistently flouted the will of its shareholders. In October, PeopleSoft's board sacked the firm's imperious boss, Craig Conway. Some board members have since made encouraging comments about selling the firm. Also in October, PeopleSoft changed its customer-assurance programme in a way which met some of the concerns Mr Strine had raised about it. Too little too late? Perhaps. But next spring PeopleSoft's shareholders get to elect the company's board of directors. Oracle has put up an alternate slate of four directors for the seven-member board; if all are elected, they will be free to dissolve the pill and so consummate the merger themselves. Mr Strine may yearn to scrap PeopleSoft's poison pill and send a clear message that American boards cannot just say no, but, given the impending board election, it will be no surprise if he just says wait.

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Russian energy firms

Ivan at the pipe

Dec 9th 2004 | RIGA
From The Economist print edition

eyevine

Russia's energy firms are viewed with suspicion as they try to expand in former communist countries

CLAIMS that Russian interests tried to bribe a Polish government minister in a failed bid to buy the Gdansk oil refinery, first made in Polish newspapers and now being pursued by a parliamentary commission in Warsaw, are rocking Poland's business and political worlds. Documents before the commission also allege that the country's richest private investor, Jan Kulczyk, offered to use his influence with the Polish president to help the Russians. Mr Kulczyk has called this idea “laughable”. The Polish president, Aleksander Kwasniewski, has been angered by suggestions that he has helped to advance Mr Kulczyk's business interests—an allegation rejected by both men. Quite apart from what it tells about the febrile state of Polish business and politics, the affair gives a rare glimpse into how some Russian firms appear to operate in central Europe, the fear and distrust they encounter and the reason why such reactions are sometimes justified.

On the face of it, the economic fundamentals ought strongly to favour Russian investment in the countries of central Europe, eight of which joined the European Union this year. Russia is a big country with a vaulting trade surplus and companies keen to diversify abroad. The central Europeans, right next door, are mostly small countries with big trade deficits and fast-growing economies, all vying for capital inflows. But problems of history and geopolitics intervene. Three of the new EU members—Estonia, Latvia and Lithuania—were occupied by the Soviet Union until 1991. Another four—the Czech Republic, Hungary, Poland and Slovakia—were ruled by communist parties answering to Moscow. The former subjects and satellites resent their past oppression and fear that Russia wants to rebuild some of its lost power and influence in the region.

Despite predictions that central European countries would get on more easily with Russia once they had joined the EU, this was not happening even before the recent political crisis in Ukraine, which has made relations worse. Sergei Yastrzhembsky, President Vladimir Putin's special representative for the EU, complained recently that the new members had brought with them a “spirit of confrontation and intolerance”. “There was not such an atmosphere”, he said, “before people came with their historical grudges, complexes and atavistic ideas about Russia.”

Older EU members, such as France and Germany, view Russia as a long-term ally going through a difficult patch which needs to be helped. Britain has been a party both to Russia's biggest inward foreign investment, when BP acquired half of a Russian oil firm two years ago; and to Russia's best-known

outward investment, the purchase of Chelsea Football Club by the oil tycoon Roman Abramovich. But the central Europeans feel themselves to be more vulnerable to Russia, and also more experienced in their dealings with it.

Viktor Orban, the leader of Hungary's right-wing Fidesz party, said when he was prime minister two years ago that he had trouble deciding whether Russian investment served “foreign trade, or foreign policy”. He was speaking in the wake of a bid by Gazprom, Russia's gas monopoly, and other friendly investors, to take over a major Hungarian chemical company, BorsodChem, provoking furious defensive moves by other Hungarian firms. Now Gazprom has fresh plans for expanding in Hungary by acquiring gas transmission assets jointly with E.ON of Germany.

Mr Orban's question was difficult to answer at the time, and has become no easier since. Some big foreign deals by Russian firms—for example, the move last year by Severstal, Russia's second-biggest steelmaker, to buy Rouge Industries, a failing American steel company—have been purely commercial deals. In no way could Russia's ownership of Rouge Industries exert any significant influence on power and policy relations between Russia and America. But in central Europe Russian firms have concentrated their known acquisitions almost exclusively in the energy sector, where they hold assets vital to the normal functioning of the host economies. They are building up similar holdings in south-east Europe and the Balkans.

This strategy can be rationalised on commercial grounds. Russia's biggest, most profitable and most international firms are, overwhelmingly, its oil and gas firms, for which acquisitions in central Europe offer incremental growth. The EU's new members import 80% of their oil and 75% of their gas from Russia, compared with 15% and 20% for the “old” EU of 15 states, meaning that Russian firms have a strong commercial interest in controlling national distribution networks there.

Bear hug

But the central Europeans fear the special relations, extending far beyond commercial considerations, that bind Russia's oil and gas companies to its government. These companies account for such a large share of Russia's economy and its trade and influence overseas, that they cannot help but function as instruments—and sometimes makers—of its foreign policy.

Gazprom controls 25% of the world's known gas reserves and supplies almost all the gas needs of central Europe and the former Soviet Union. In many ways it has become ways Russia's most useful instrument for projecting power, along with its army. For much of the 1990s, and occasionally since then, a quarrel between Gazprom and a neighbouring government over gas prices or distribution, often leading to a temporary cut-off in deliveries, was the surest sign of a political quarrel between that country and Russia. The government owns 38% of Gazprom directly, and may be in the process of pushing its stake above 50% by merging Gazprom with Rosneft, a state-owned oil company.

Most of Russia's oil industry was privatised in the mid-1990s, but it has come under much tougher political control since Mr Putin took office four years ago. As if to reinforce the growing identification of the Russian energy industry with the Russian state, veterans of the KGB and other Russian security services have appeared with increasing frequency doing supposedly civilian jobs in the senior ranks of Russian big business and diplomacy.

The most independent-minded of the private oil firms, Yukos, modelled itself on western competitors and sometimes disagreed openly with the Kremlin. It has been hounded to the verge of bankruptcy by Russia's tax authorities and the public prosecutor. Its main assets are soon to be auctioned, with Gazprom a likely bidder. Yukos's collapse leaves Lukoil, a company much more deferential to the Kremlin, as the uncontested industry leader.

The breaking of Yukos has had a devastating effect on Russia's image in central Europe, as well as farther afield. Because of its “western” profile, Yukos was the only Russian oil company ever

truly welcomed in central Europe as a direct investor, and then only very recently. Optimists applauded its booming profits and market capitalisation as proof that Russian business was indeed "normalising" and becoming just like business everywhere else in the capitalist world. Now, with Yukos about to be broken up and its assets redistributed under Kremlin supervision, the optimists look like fools, and the governments with Yukos on their soil are seething. The Slovak government wants to buy back the 49% of Transpetrol, its national pipeline company, which it sold to Yukos two years ago. If the government of Lithuania had more money, it would probably try to buy back Mazeikiu Nafta, a big oil refinery bought by Yukos in 2002.

All of the scandalous elements popularly (if wrongly) associated with Russian capital—spies, bribes and political intrigue—have come together to spectacular effect in Poland, where the biggest row in almost a decade has been triggered by a parliamentary commission of inquiry investigating the affairs of the biggest national oil company, PKN Orlen, which is 28% owned by the state. The original purpose of the inquiry was to decide whether Poland's socialist government had acted illegally when ousting a previous chief executive of PKN Orlen in 2002. But that question has been overshadowed by a much juicier controversy surrounding the aborted privatisation of a big oil refinery at Gdansk that same year.

According to notes from the Polish intelligence services, which were passed to the inquiry and have been much disputed, Russian interests had given or promised a $5m "commission" to a Polish minister and to a leading oil-industry figure (not Mr Kulczyk) in exchange for ensuring that a Russian company won the bidding. But the Polish government cancelled the sale, leaving the Russians very unhappy—a message they communicated a few months later in a style worthy of John le Carré.

Mr Kulczyk, a Polish tycoon whose holdings include almost 5% of PKN Orlen, was invited to a meeting in Vienna in July last year by UES, Russia's electricity monopoly. There he found the Russian side represented by a Russian spy called Vladimir Alganov, who had served as a KGB officer in Warsaw in the 1980s and who later helped to set in motion an espionage scandal that brought down Jozef Oleksy, a Polish prime minister, in 1996. Mr Alganov introduced himself as UES's manager responsible for nuclear power stations. In the course of a conversation about power transmission—UES wanted to export power from Kaliningrad to Germany, across Poland—Mr Alganov allegedly mentioned Gdansk and the $5m bribe. Allegedly, Mr Kulczyk responded by offering to use his influence with "number one"—meaning Mr Kwasniewski, Poland's president—to have the privatisation reopened. Mr Kulczyk has dismissed this account of the conversation, which was apparently obtained indirectly by Polish intelligence from Mr Alganov.

Climate change

Part or all of the scandal may yet prove to be a Russian provocation. But if so, it has backfired by portraying Russian business in such a sordid light that all of Russian-Polish relations may be set back. Mr Kwasniewski said recently that Mr Putin had often raised privately with him "the bad climate for Russian investments in Poland". With the Gdansk scandal, Mr Kwasniewski said, "the climate will be even worse. We are maintaining that Russian investments are *a priori* bad, in and of themselves harmful, KGB investments. We have pushed ourselves into a trap."

But if a knee-jerk fear of Russia represents one sort of trap for central Europe, then energy dependence represents another. Last week the International Energy Agency expressed concern that the EU as a whole was becoming too reliant on Gazprom, which could use its power as a monopoly supplier to push up gas prices. As for oil, hopes that other Caspian Sea producers might soon compete with Russia in Europe are having to be scaled back. This year, under pressure from Russia, Ukraine has reversed the flow of a new pipeline that was built to carry Caspian oil via the port of Odessa up towards Poland. Instead, it now will carry Russian exports out through Odessa to western Europe.

In the past Russia has proved willing to withhold oil and gas supplies to bully the Baltics, and has done the same to post-Soviet countries still tied closely to it, such as Georgia and Belarus. This behaviour gave most central European countries, even those watching from a distance, strong arguments for favouring western investors when they began to privatise their oil refineries, fuel distributors and gas companies five to ten years ago.

The Czech Republic, though usually considered to have relatively smooth relations with Russia, kept Russian bidders at bay when it started to privatise its national oil-refining and fuel-distribution company, Unipetrol in 2001. (The process, because of a failed first bid, was completed only this year with a sale to Poland's PKN Orlen.) In Poland and Hungary, a wish to circle the wagons against Russia has been one motive for intermittent talks about merging the two main national oil firms, Hungary's MOL and Poland's PKN Orlen. Poland now seems to fear that this would merely create a company even more attractive to a Russian bidder, so the final answer may yet prove to be a three-way merger between MOL, PKN Orlen and the Austrian oil firm OMV, which owns 9.1% of MOL. The distant prospect of a merger gives all three firms a strong incentive to add assets in the meantime, so as to maximise clout in the final entity. On present form OMV would be in the driving seat, especially if it can digest successfully its latest ambitious acquisition, a controlling stake in Petrom, Romania's national oil company.

Evasive and corrupt

The most extreme—and least successful—defensive action against Russia may have been the one taken by Lithuania when privatising its oil refinery, Mazeikiu Nafta, five years ago. The economy minister of the day cheerfully summed up his policy as being to “keep Ivan from the pipe”. But Ivan was already there, since Mazeikiu relied entirely on Russian oil, most of it from Lukoil, which wanted to buy the refinery. When Lithuania sold Mazeikiu cheaply to an American gas company, the Russians discovered all manner of technical reasons for not sending oil. The Americans promptly sold Mazeikiu to Yukos. Arguments over those deals helped bring down two Lithuanian governments. And with the collapse of Yukos, the political agonies over Mazeikiu seem likely to continue.

Wealth by stealth

Selected Russian oil and gas investments in central Europe

Country	Company	Activity	Owner/investor	% owned
Bulgaria	Lukoil-Neftokhim	Oil refining and petrochemicals	Lukoil	58
	Topenergy	Gas trading and engineering	Gazprom	100
	Overgas	Gas distribution	Gazprom	50
Estonia	Eesti Gaas	Gas distribution	Gazprom	37
Hungary	BorsodChem	Chemical manufacturing	Stalked by Gazprom, 2000	na
	Panrusgas	Gas importing	Gazprom	50
Latvia	Latvijas Gaze	Gas distribution	Gazprom	34
	LatRos Trans	Oil export pipeline	Transnefteprodukt	34
Lithuania	Lukoil Baltija	Fuel distribution and filling stations	Lukoil	100
	Lietuvos Dujos	Gas distribution	Gazprom	34
	Mazeikiu Nafta	Oil refinery and export terminal	Yukos	54
Poland	Europol Gaz	Gas export pipeline	Gazprom	48
	Gas Trading	Gas imports	Gazprom	35
Romania	Petrotel-Lukoil	Oil refining	Lukoil	93
Slovakia	Slovrusgaz	Gas trading	Gazprom	50
	SPP	Gas distribution	Gazprom	up to 16.3
	Transpetrol	Oil pipeline	Yukos	49

Sources: Austrian Energy Agency; company reports; Linklaters

Anecdotal evidence suggests that Russian companies have made a difficult situation worse by bringing with them into foreign markets the evasive and often corrupt business practices which were universal in Russia in the 1990s, and which remain commonplace there even today. Transparency International ranked Russia equal 90th out of 146 countries this year for the perceived severity of domestic corruption. And when Transparency surveyed the propensity of companies to offer bribes in the developing world in 2002, it put Russian firms at the very top of the list, just above Chinese ones, saying that both countries used bribes “on an exceptional and intolerable scale”.

Part of the problem is that the vast majority of Russian capital overseas has been exported illegally. Tax regulations and exchange controls have been simplified under Mr Putin, but they are still daunting, and a few years ago they were almost impossible to negotiate honestly. The result has been a torrent of flight capital from Russia over the years, but only a trickle of officially registered foreign investment. Even Russian companies with permission to invest abroad have routed their transactions through shell companies and third countries in order to minimise Russian taxes and to make their foreign assets much easier to sell or hide later. This gives them hidden cash reserves overseas, invisible to their own auditors and everyone else, to do with as they like.

Recent attempts to estimate Russia's unreported foreign investments, and also to put a value on foreign assets inherited by Russian companies when the Soviet Union collapsed, have resulted in a huge upward revaluation of Russian foreign direct investment. Last year the United Nations Conference on Trade and Development estimated the whole outward stock of Russian FDI at $18 billion in 2002. This year the Commission has put the figure at a more plausible $52 billion for 2003, equivalent to one-third of Russia's estimated capital outflow in the past decade, and enough to put Russia on a par with Brazil or Austria as a foreign direct investor. If one-quarter of that total went into central Europe—an arbitrary estimate, but not an absurd one—that would make Russia the region's third-biggest foreign investor after Germany and the Netherlands, roughly equal with France.

Will central Europeans ever be at ease with investment from their mighty neighbour? The Baltics may well be a special case. Russia has used energy policy against these countries in the past, and it works to influence them now, whether openly through propaganda and diplomacy or covertly through espionage. Distrust of Russia is strong enough there to be a destabilising factor in itself. Other central European countries surely have much less to fear. They need to learn to accommodate Russian companies which approach business with different rules, or fewer rules, but which plan for the long term, and will adjust their behaviour if that is what the business environment demands. As one Polish commentator said recently, reflecting on the Gdansk scandal:

> It is not the “nationality” of capital that is important, but how its owners behave in a given market. And whether the country in which that capital operates is able to enforce proper behaviour, compliant with the law and common standards. From that point of view, it is the weakness of the Polish state that is the problem, not the fact that this or that company comes from Russia. Why isn't Gazprom a problem in Germany but is a problem in Poland? Because the Polish state is weak. That weakness concerns many elements, from the judiciary to the politicians.

Here, exactly, is where the EU's new members have the power to change things for the better. In the short term, EU entry may have emboldened them to voice their fears about Russia, making relations temporarily worse. But in the longer term, with luck, EU membership will strengthen them internally to the point at which such fears will no longer hold sway.

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The global housing market

Flimsy foundations

Dec 9th 2004
From The Economist print edition

Powerstock

Residential-property prices are now falling in Britain and Australia, but have taken off in America and France

IN THE past three years, the total value of residential property in developed economies has increased by an estimated $20 trillion, to over $60 trillion. Granted, that increase is partly explained by the decline in the dollar; still, it is double the $10 trillion by which global share values climbed in the three years to 1999. Is this the biggest financial bubble in history?

The growing impact of housing markets on economies prompted *The Economist* to launch its global house-price indices in early 2002; these now cover 20 countries, using data from lending institutions, estate agents and national statistics. Our latest quarterly update shows that prices have risen over the past year by around 10% or more in 11 of the countries that we track (see table). Top of the league is South Africa, where prices surged by 35% in the year to the third quarter, pushing it into first place ahead of Hong Kong (31%).

Among developed countries, Spain has enjoyed the biggest rise, of 17%, over the past year, much the same rate as in 2003. However, in Australia, which topped the table for most of last year, house prices are now falling. According to official figures, average prices in the third quarter were still 8% higher than a year ago, but private-sector figures suggest that prices have fallen sharply in recent months. The Commonwealth Bank of Australia's index, which is more timely because it is based on prices when contracts are signed rather than at settlement, shows that house prices in Sydney were 15% lower in September than in December 2003; nationwide, prices fell by an average of 10%.

House-price inflation has also slowed significantly since last year in New Zealand and Ireland. In Britain, figures published by the Office of the Deputy Prime Minister show a 14% rise in prices in the year to the third quarter, up from 11% a year ago. But more up-to-date figures show that prices are now falling. According to the Halifax index, compiled by a big mortgage lender, prices fell in three of the four months to November. The volume of sales is

also down sharply, as buyers are unwilling to pay asking prices. This in turn may signal further price falls to come. Barclays bank predicts that prices could sink by 20% over the next three years. Even the Bank of England has given warning that prices will fall.

In some countries, notably America, France and Sweden, the property market is still heating up. The average price of American homes jumped by 13% in the year to the third quarter—the fastest increase on record in real terms. Prices rose at double-digit rates in half of all American states; in five states, including California, and in Washington, DC, they soared by more than 20%. French house prices have increased by 15% over the past year, causing the Bank of France to express concern about the risk of a speculative bubble.

Calculations by *The Economist* suggest that house prices have hit record levels in relation to incomes in America, Australia, Britain, France, Ireland, the Netherlands, New Zealand and Spain. In other words, ratios of prices to incomes are now above levels that have proved unsustainable in the past. Taking the average ratio of house prices to incomes in 1975-2000 as a baseline, American house prices are now almost 30% overvalued.

The Economist's house-price indices

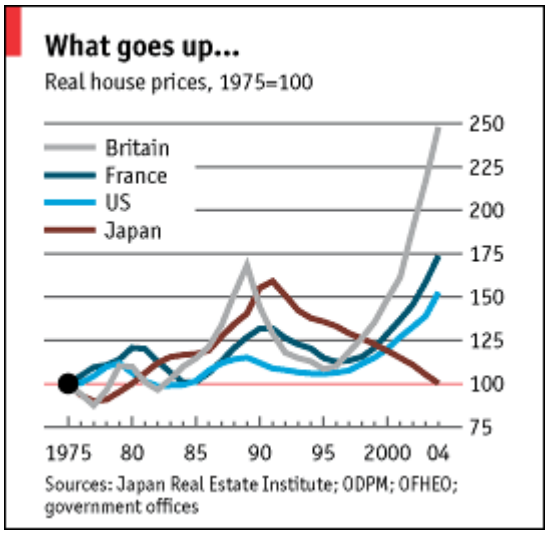
% change on a year earlier

	Q3 2004*	Q3 2003	1997-2004
South Africa	35.1	20.9	227
Hong Kong	31.2	-13.6	-49
Spain	17.2	16.5	149
New Zealand	16.4	21.2	56
France	14.7	11.5	76
Britain	13.8	11.0	139
United States	13.0	6.0	65
Ireland	10.8	14.8	187
China	9.9	4.1	*na*
Sweden	9.8	5.5	81
Italy	9.7	10.6	69
Belgium	9.3	5.5	50
Australia	8.2	17.6	112
Denmark	7.3	3.4	50
Canada	6.7	6.5	43
Netherlands	3.3	1.9	76
Switzerland	2.2	2.4	12
Singapore	*nil*	-2.3	*na*
Germany	-1.7†	-4.5	-3
Japan	-6.4	-4.8	-24

*Or 2004 latest †Second half 2003

Sources: ABSA; Bulwien; ESRI; Japan Real Estate Institute; Nomisma; NVM; ODPM; OFHEO; Quotable Value; Stadim; Swiss National Bank; government offices

If real interest rates are permanently lower, this could justify higher prices in relation to incomes. For example, real interest rates in Ireland and Spain were reduced significantly by these countries' membership of Europe's single currency. But several studies conclude that lower interest rates cannot explain all of the surge in house prices.



Japan provides a nasty warning of what can happen when bubbles burst. Japanese property prices have dropped for 13 consecutive years, by a total of 35% from their peak in 1991 (see chart). Yet the 36% rise in real house prices in Japan in the seven years to 1991 was actually less than the increase over the past seven years in all but one of the eight countries listed above where prices appear overvalued.

Don't mention the B-word

In a recent speech, Alan Greenspan, the chairman of America's Federal Reserve, insisted that the growing concerns about an American housing bubble were much exaggerated. He went on to argue that the housing market is less prone to bubbles than the stockmarket, because homeowners cannot buy and sell their houses as easily as speculators buy and sell shares. People have to live somewhere and large transaction costs discourage trading.

Yet some economists reckon that bubbles are, if anything, more likely to develop in housing markets than in stockmarkets. One reason is imperfect information: no two houses are exactly alike and there is no central exchange where prices are instantly recorded. A second is the absence of short-selling. Suppose bullish investors push prices above their equilibrium level. In markets for shares or foreign exchange, such price rises might be moderated by other investors selling for future delivery in the hope of buying more cheaply later. But there are no organised futures or options markets for property, so with no short-sellers, optimists can keep driving prices up. Buyers' expectations about future house prices also tend to be based heavily on recent trends, so a rise in prices will also tend to boost demand further.

A third factor that tends to encourage bubbles is that banks have an incentive to lend as much as possible when property prices are rising, because this raises the value of their collateral. This gives prices an extra upward shove. But when prices fall, banks pull out, amplifying the bust.

There are plenty of symptoms of a bubble mentality in the United States, not least the surge in the turnover of existing homes to a record rate of 9% this year. Investors have been buying new properties and reselling within a year in the hope of a large gain. Economists at Goldman Sachs are concerned about signs of excess supply. The rate of growth in the housing stock exceeds the rate of growth in the number of households by a bigger margin than at any time in the past 40 years.

The global housing boom has been unusual in its strength, duration and ubiquity. Never before have so many countries had housing booms at the same time, driven largely by low interest rates. However, in its latest *World Economic Outlook*, the IMF warns that just as the upswing in house prices has been a global phenomenon, so will any downturn be—with corresponding adverse implications for global economic activity.

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The CAO derivatives fiasco

Fools rush in

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A reminder of the risks of investing in Chinese companies

CRASH landings do not come much more spectacularly than that of China Aviation Oil (CAO). The Singapore-listed subsidiary of mainland China's monopoly supplier of jet fuel sought court protection on November 29th after racking up $550m of losses trading oil derivatives.

It is hard to decide which part of the tale is most hair-raising. CAO freely acknowledges that it speculated in crude-oil futures, rather than just hedging its position, and bet wrongly that prices would fall. It blew through its own $5m internal trading limits back in 2003, but kept doubling up in an attempt to make good the deficit and told nobody about its mounting losses for over a year. And as recently as October 20th, its parent sold $120m-worth of shares in the subsidiary to outside investors to cover losses, without telling those investors that anything was amiss.

This combination has turned a stockmarket darling into the source of the biggest trading scandal since Nick Leeson (as it happens, a derivatives trader in Singapore) brought down Barings, a venerable British bank, in 1995. And it has exploded the business reputation of Chen Jiulin, the 43-year old chief executive of CAO's Singapore arm, who was voted one of 40 “New Asian Leaders” by the World Economic Forum last year. Mr Chen, who suddenly left for China on November 30th, was arrested on his return to Singapore on December 8th and then released on bail. His company may be saved: it is in talks with Temasek, the holding company for the Singapore government's investments, which bought shares in the October sale.

CAO's collapse raises fresh questions about the standards of corporate governance at Chinese firms at a time when more and more are seeking international listings and foreign investors are increasingly eager to buy into them. And it also raises questions about the role of financial intermediaries, such as investment banks and exchanges, that are keen to gain from oiling this process.

Companies anywhere can be hit by fraud. But China's nascent capitalism seems to be producing a particularly virulent strain (see table). The country's authorities have worked hard to impose a framework of rules for listed companies, including a requirement to produce quarterly results. But the gap between theory and practice is wide. There is no effective enforcement and corporate governance is poor. Chinese companies, which are state companies run by political fiat or private firms controlled by entrepreneurs or family members, have little experience in looking after minority shareholders and only a partial understanding of such concepts as board independence, independent auditing of results and the need for proper risk control.

Scandal sheet

Selected Chinese companies' problems

Company	Date	Problem
Skyworth	2004	TV-maker's top management arrested for theft of funds
D'Long	2004	Conglomerate blew up after exposure of fictitious growth through acquisitions and misappropriation of $725m
Shanghai Land	2004	Property developer collapsed after chairman jailed for fraud
Euro-Asia Agricultural Holdings	2002	Orchid grower collapsed after inflating revenues. Chairman jailed for fraud and bribery
Gitic	1999	Guangdong's investment vehicle went bust, owing over $5bn

Sources: CLSA/ACGA; company reports

A particular issue is the lack of transparency in dealings between a listed subsidiary and the state-owned parent which continues to control it. “The scope for related party transactions is vast in China,” says Jamie Allen, secretary-general of the Asian Corporate Governance Association. “Minority investors can't tell if their interests are being harmed.” The lack of board independence, a problem even in Hong Kong, is egregious on the mainland: “The Communist Party controls senior appointments. There is clearly a political element to how these companies are run.”

It has not helped that China has jealously guarded its political prerogative to deal with its own black sheep: foreign regulators were denied access to the bosses of Shanghai Land, Euro-Asia and Bank of China's Hong Kong subsidiary, even though these companies had foreign investors. That CAO's Mr Chen returned to Singapore to face the music is welcome.

However, China and its companies are not the only ones to blame. Stock exchanges abroad have loosened regulations to attract Chinese listings. The London Stock Exchange has been wooing Asian flotations, such as that of Air China, due next week, with claims that it has less strict requirements than New York. The Singapore Stock Exchange, home of CAO, loosened its disclosure rules a few years ago. Mak Yuen Teen, co-director of the Corporate Governance Centre at the National University of Singapore, argues for a return to stricter rules to avoid a race to the bottom, since “smaller exchanges like Singapore may be a fourth or fifth choice for Chinese companies that cannot get to the US or Hong Kong.”

In addition, Mr Allen points to the role played by banks and other advisers keen to profit from the listings. Neither Deutsche Bank, which helped CAO place its October share issue, nor Ernst & Young, the company's auditor, is being investigated in connection with the affair. But neither can be proud of its role.

Not everyone is slacking: America reacted to its own corporate-governance scandals by implementing tighter regulation, in the form of the Sarbanes-Oxley act—and, perhaps as a consequence, has seen a slowdown in foreign listings on the New York Stock Exchange. Yet investors across Asia, where companies are less accountable, remain relatively unprotected. If China wants to continue selling its firms and attracting foreign capital to build successful multinationals, it will have to practise good corporate governance, not just pay lip service to it.

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World Trade Centre insurance

One into two

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Having lost one legal case to insurers, the towers' leaseholder wins a second

SEVEN months ago, a jury in lower Manhattan ruled that under the forms covering insurance of the World Trade Centre, the striking of the twin towers by two aeroplanes constituted only one “occurrence”. Consequently, Larry Silverstein, who had recently leased the Trade Centre complex, was entitled to one payment, not two—a difference of $3.5 billion. On December 6th, in the same courtroom with the same judge presiding, another jury decided that under the documents used by nine other insurers the attacks were two events, thus qualifying for two payments. The verdict will provide Mr Silverstein with as much as $1.1 billion extra for rebuilding the Trade Centre. It will also ensure that he remains in control of the project.

Why, after two weeks of deliberation, did the second jury come to a different conclusion from the first? The main reason lay in the preliminary paperwork signed by the underwriters. Because the Trade Centre had been leased to Mr Silverstein only weeks before the attack, the final insurance contracts had yet to be signed. The insurers in the first trial had signed a form with a much tighter definition of an “occurrence” than in the form signed by the nine insurers in the second trial. In addition, the insurance companies' claim that they always defined “occurrence” precisely may have been undermined by testimony that they had been flexible in other cases—for example, involving sequences of hurricanes—when it suited them.

The insurers will appeal, as Mr Silverstein did against the first verdict (his appeal has not yet been heard). All of the primary insurers have already set aside money against defeat, so should suffer no significant further dent to their earnings. Reinsurers, though, could be hurt. Mr Silverstein has already received $2 billion in settlements and, with the current victory, could get up to $4.6 billion. By agreement, the money will go into the rebuilding of the Trade Centre. It will cover only half of the expected cost of the commercial space.

Typically, such uncertainty would place a damper on the project. Builders and their financiers like to have money up front. But Mr Silverstein is a man in a hurry. Seven World Trade Centre, a skyscraper near the twin towers that was destroyed in the attack and is now being reconstructed, was recently topped off, months ahead of schedule. Not a single tenant has been signed up and the vacancy rate is high in lower Manhattan, but work on the façade is nevertheless proceeding without delay.

A cornerstone was laid on July 4th for the largest of the buildings to be constructed on the site. “Nothing,” says Mr Silverstein, “will deter us.”

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Foreign-exchange trading

Free for all

Dec 9th 2004
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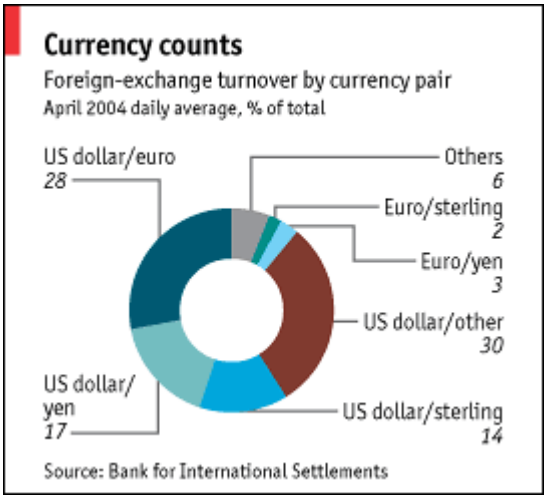
Could the world's most liquid market become still more efficient?



VOLATILE currency markets bring broad grins to the faces of foreign-exchange traders, especially when the dollar is involved. The greenback features in nearly 90% of the $1.9 trillion-worth of foreign-exchange trades that take place daily (see chart). With the dollar testing one new low after another against the euro (this week it breached $1.34), shorting it has been one of the most lucrative bets around.

The foreign-exchange market, widely considered the world's most liquid, is growing apace: up by 36% (at this April's exchange rates) between 2001 and 2004, says the Bank for International Settlements (BIS). Not long ago, the fear was that it might lose some of its slickness: business was being concentrated among a few big banks trading among themselves, and the birth of the euro meant that several currencies, and thus opportunities for arbitrage, disappeared. Yet the market is as lively and liquid as ever. Why?

Most trading is still done by banks—and by even fewer of them. Derivative and forward trades, where banks are especially strong, are mainly by voice, but spot trades are largely electronic: one online trading platform, a big interbank system called EBS, specialising in euro-dollar and yen-dollar pairs, processes an average of $100 billion a day. As the dollar slid, $203 billion passed through it one day this month.

However, interbank trade is less dominant than it was. Risk capital has been coming in from hedge funds. These and other non-bank financial groups trading with banks now account for 33% of volume, says the BIS, up from 28% in 2001 and 20% in 1998. Most hedge funds trade smaller amounts than the banks. “Long-short” funds may keep just 5% of portfolios for currency hedging. But macro funds and “managed futures” funds, says Huw van Steenis of Morgan Stanley, invest much more in currency trading. This year they have done much better from it than from fixed income, commodities or equities.

The hedge funds and the online platforms might both benefit from bypassing the banks. At present, hedge funds wanting to trade foreign exchange usually ring up their bankers and ask for a quote. In order to use the big online interbank systems such as EBS or Reuters they must go via a bank, partly because they lack the huge credit needed to trade directly.

EBS and Reuters want to deal with hedge funds directly, and change is coming. This month EBS is piloting a structure that allows hedge funds to trade on its platform, using surplus credit from deep-pocketed investment-banking partners. If successful it would be rolled out next year. Reuters is also mulling this model. Meanwhile lots of other online platforms such as HotspotFX, Currenex, FXall or fxAuctions.com (which opened this week) are wedging themselves into the market, aiming to allow hedge funds and others to trade at close to interbank prices. FXall's volumes exceed $25 billion a day.

Some also think that traditional exchanges, on the lookout for new business, might also get more involved than in the past. The Chicago Mercantile Exchange, for example, handled an average of only $23 billion a day, mainly in futures, in the 11 months to November, but the figure has been rising fast. With so many trying to muscle in, the liquidity and scale of the market look anything but endangered.

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About sponsorship

Famine insurance

Hedging against the horsemen

Dec 9th 2004
From The Economist print edition

How derivatives could make aid to the starving more effective

ASK an Ethiopian peasant what would most improve his life, and he is unlikely to mention weather derivatives. Nonetheless, some brainy people at the World Food Programme (WFP), the UN body charged with saving the starving, think they could save more people by using arcane financial instruments.

A typical famine might unfold like this. First, the rains fail. Then the harvest fails. Then people start to go hungry. After a while, the television cameras arrive. Western donors, moved by pictures of swollen-bellied tots, reach into their pockets. Eventually, truckloads of food aid arrive. But they arrive too late for many.

This is slightly over-simplified, but it illustrates a real problem. If help arrives before people start starving, fewer will die. But it is only when people start to die that the money to save them starts flowing in.

Some kind of catastrophe insurance ought to help. Commercial farmers already buy insurance against bad weather. Peasants cannot afford to, but a body such as the WFP could do so on their behalf.

This could work in one of two ways. The WFP could buy an insurance policy that paid out when, say, the rainfall in Ethiopia was below a certain level. Or it could issue “catastrophe bonds”. In years of good or mediocre rainfall, the WFP would pay interest, out of its income from donors, but when drought came, bondholders would lose their principal.

Should disaster strike, the WFP would have ready cash. The WFP thinks its ideas would be cost-effective, though you might think investors would demand a stiff return for what looks like a high risk of losing money. Big reinsurance firms in rich countries may be tempted because they currently have very little exposure to the weather in the southern hemisphere, and it is always wise to diversify one's portfolio. Richard Wilcox, the man at the WFP assessing the scheme's feasibility, says he thinks it could be up and running by 2007.

Sceptics may grumble that the real cause of famine is bad government, not bad weather. This is true, in the sense that well-governed countries cope much better with the effects of drought, whereas ill-governed ones are more likely to collapse into civil war, which tends to spoil the harvest. But bad government is hard to measure, and therefore hard to insure against.

Rainfall, by contrast, is easy to measure. It also varies enormously from year to year. In Ethiopia, for example, where some 90% of people rely on rain-fed agriculture, household incomes rise dramatically when the rain falls and fall dramatically when it does not.

In bad years, families sell their possessions to buy food. Worse, they sell their means of production, such as tools and livestock, so even if the rains are better the next year, they may not be able to take advantage of this. Even worse, they all tend to own the same types of goods and they all try to sell them at the same time—ie, as soon as they can see that the rains will fail—so they receive low prices for them.

All this makes it excruciatingly hard for Ethiopian peasants to break out of poverty. They may accumulate a surplus in good years, but they tend to lose it all in bad ones. But supposing they knew that food aid would arrive promptly when the rains fail? In that case, the WFP argues, they might not rush to sell their ploughs, so they would be better able to take advantage of good weather the next year. Famine insurance, in other words, could offer more than a Band-Aid for the poorest.

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Economics focus

Debt and dotage

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Should the American government borrow trillions to finance pension reform?

THE rest of the world may be fretting about America's enormous budget deficit; but if George Bush is worried, he hides it well. Along with tax reform (discussed on this page on November 27th), the reform of Social Security, America's public pension system, tops Mr Bush's economic agenda for his second term. The main question so far seems to be how much more America will have to borrow in order to transform Social Security from a tax-financed scheme into one based partly on private accounts.

So far, Mr Bush has set out only his broad principles, not details. Any reform must lead to the creation of individual accounts in which Americans can save for their retirement. It must not cut pension benefits for today's retirees or for those nearing retirement. And it must not lead to higher taxes.

Most proposals focus on allowing employees to divert some of their payroll-tax contributions into private accounts. Because Social Security is a pay-as-you-go system, in which today's payroll taxes (12.4% of earnings, split evenly between employer and employee) pay for today's pensions, any such diversion creates a gap in the government's books, which must be made up somehow—through higher taxes or savings or, most likely, higher debt. What is more, like most rich countries' pension schemes, Social Security promises pension payments that far exceed its likely revenues, by around $4 trillion, in present-value terms, over the next 75 years.

On December 6th a White House spokesman confirmed that Mr Bush's plans would indeed mean more borrowing. How much more depends on the details. At the modest end of the current proposals is an idea put forward in 2001 by the Commission to Strengthen Social Security, which Mr Bush appointed. This would allow individuals to switch four percentage points of their payroll-tax contributions, up to a maximum of $1,000, into individual accounts. Their promised benefits from Social Security would be cut, though by less than the amount of diverted revenue plus interest. To plug the long-term hole in Social Security's finances, promised benefits would be cut for everyone. Extra borrowing of $1.5 trillion-2 trillion over the next decade would be required, but the state pension programme's unfunded liabilities would eventually be wiped out.

Some conservative Republican Congressmen are pushing a more dramatic idea. They would like to divert up to half of payroll-tax contributions to individual accounts. Some of them would guarantee that total benefits (ie, public plus private) would not be cut, and would rely on spending cuts elsewhere in the budget, high investment returns and tax revenue from higher economic growth to make the numbers add up. Meanwhile, the government would have to borrow much more than under the commission's plan: $5 trillion over the next decade alone. By way of comparison, America now has $4.3 trillion of government debt outstanding.

All this new debt sounds frightening, but advocates of reform say that borrowing now will help stave off problems in the future. If Americans have individual accounts and therefore receive less from the state when they retire, Social Security's future liabilities will be reduced. It is worth borrowing now and paying interest in order to bring this about. To make this purpose clear, Republican lawmakers want borrowing related to Social Security not to be counted in the government's normal accounts.

Opponents are aghast. Big increases in borrowing, they fear, will widen America's already gaping budget and current-account deficits and push interest rates up. Trying to hide the profligacy by fiddling the government accounts (one or two critics have muttered “Enron”) will fool no one.

Who is right? In theory, creating private accounts need not make the hole in the government's finances

bigger than it already is. The government is merely reducing its implicit future liabilities and increasing its explicit current liabilities. If financial markets are efficient, they should spot this and ought not to demand higher interest payments on government bonds. The current-account deficit (the difference between national spending and national income) need not widen because national saving would be unaffected by the reform. Although the government would be borrowing more to make up for the money diverted into individual accounts, private saving would rise by exactly the same amount.

Promises and commitments

In practice, the macroeconomic consequences might be less benign. First, it is not clear that financial markets will treat explicit government debt in the same way as implicit future promises to tomorrow's retirees. It is much easier to renege on the latter than to default on the former: Wall Streeters have probably assumed that some of that $4 trillion gap in Social Security will not be filled in any case.

Second, it is hard to be sure about the effect of debt-financed reform on national saving. It is possible that saving might rise, if the very existence of private accounts encourages low-saving Americans to take responsibility for their retirement and put aside more money. It is also possible that Americans might save less, if they believe that individual accounts are a more reliable means of support in old age than the existing system.

In any event, the creation of private accounts will not in itself eliminate the unfunded liabilities implicit in today's pension system. That, however, is what the politically alluring proposals from some Republicans in Congress seem to assume. But as Gregory Mankiw, head of Mr Bush's Council of Economic Advisers, said recently, there is no free lunch: if the sums are to tally, and if higher taxes are off limits, benefits will have to be cut. The question is whether Mr Mankiw's boss will listen.

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Third-world biotechnology

Southern comfort, eastern promise

Dec 9th 2004
From The Economist print edition

Imaginechina

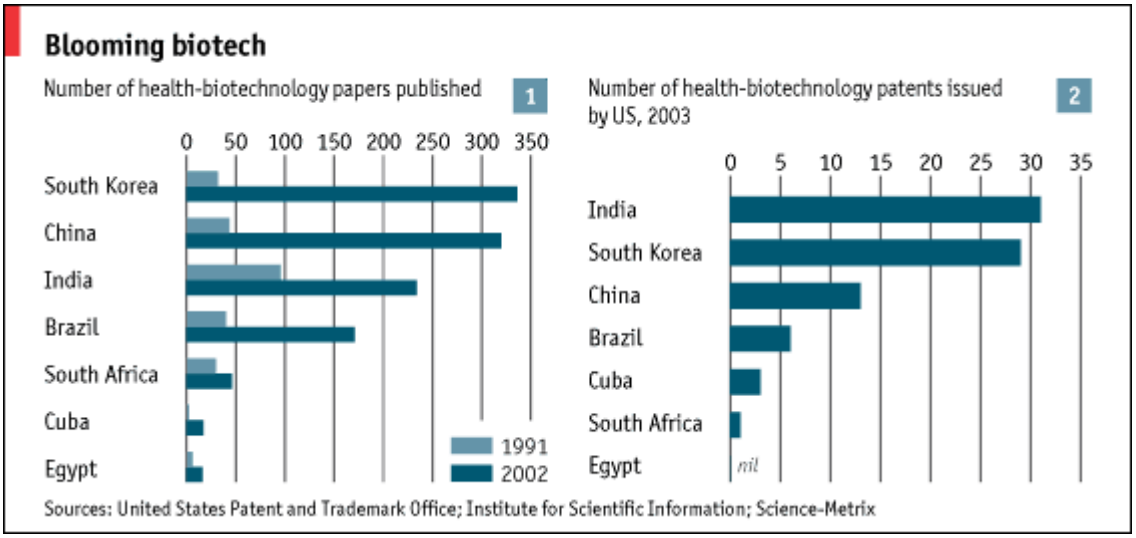
How biotechnology from poor countries can tackle local problems

Get article background

“THE future belongs to science and those who make friends with science,” Jawaharlal Nehru, India's first prime minister, observed. But cutting-edge research—the stuff of shiny labs and brainy boffins—is seen largely as the preserve of Europe and America, not something to be found in poor places such as India. Yet India, China and several other developing countries have shown they can move beyond western imitation to homegrown innovation in certain fields, such as telecommunications and information technology.

The same is increasingly true of biotechnology, argues a report just published in *Nature Biotechnology* by a group at the University of Toronto. The study looks at the state of medical biotechnology in six developing countries—Brazil, China, Cuba, Egypt, India and South Africa—and one recently industrialised one, South Korea, to understand what it takes to build a healthy biotech sector. Not only is such development good for domestic economies, says Peter Singer, director of the Joint Centre for Bioethics at the University of Toronto, but it can also provide more appropriate and affordable solutions to health-care problems in poor countries—diseases and regions which are not as attractive, or accessible, to western researchers.

Many of the countries studied, which began investing in biotech in the 1980s, are starting to see the fruits of their labour. The number of scientific papers on health biotechnology published by researchers in Brazil and Cuba, for example, more than tripled between 1991 and 2002. China's output grew a whopping seven-fold (see chart 1). Some of this research is very advanced indeed. China is making a name for itself in genomics (see article), gene therapy and stem-cell research, luring back émigré researchers with the promise of funding, facilities and fewer qualms about such research than, say, America. Such high-tech research may seem remote from the needs of poor people dying for lack of vaccines and other basic advances. But the report finds that the countries surveyed are also taking the lead in research into local problems. Brazilian scientists, for example, publish extensively on tropical afflictions, such as Chagas disease.



Beyond pure research, and into development, China and India are increasingly successful at patenting their biotech discoveries in America, a measure of how innovative, and commercialisable, their work has become since the early 1990s, when such awards were almost non-existent (see chart 2). That this is still a far cry from the thousands of health-biotech patents awarded to Americans each year is hardly surprising. Much of the biotech industry in the developing world is based on copying western innovation. But such generic manufacturing can be a springboard to more innovative activities. India's pharmaceutical firms are playing an important role in the global fight against AIDS by selling generic versions of anti-retroviral drugs at a fraction of the price charged by their western inventors in the rich world. Yet one of them, Ranbaxy, which is based in Delhi, is also moving into original R&D, and has signed agreements with western drug firms, among them GlaxoSmithKline. Whether a shift to drug discovery will also mean such firms are less interested in pursuing diseases of the poor remains to be seen, and is certainly a worry for health-care activists.

Nor are those activists pleased with the prospect of stricter patent laws to be introduced in many countries next year. As part of its membership of the World Trade Organisation, India is scheduled to amend its legislation in order to recognise product patents on pharmaceuticals. This is good news for the biotech industry, since patent protection should encourage foreign investment and technology transfer. Yet health-care activists marched on India's parliament this week to protest against the amended legislation. While the new laws should not affect Indian companies' existing production of most anti-HIV medicines, according to Ellen 't Hoen, a policy expert at Médecins Sans Frontières, an international medical relief agency, she worries that the new law will restrict firms' ability to produce cheap copies of newer medicines for HIV, cancer and other conditions. That could hamper future therapy in the developing world.

Strong medicine

There are plenty of other hurdles that the countries studied in the report need to tackle before their biotech blossoms fully. Brazil needs better links between academia and industry. Egypt's budding biotechnologists are short of cash from both government and private sources. India's regulatory system is slowing down product development. South Africa needs to do more to reverse its brain drain, and train more researchers to boost their ranks.

There are many elements to success in biotech, including strong political commitment, steady long-term funding, and solid education and health-care systems. But according to Dr Singer's colleague Abdallah Daar, the real trick for developing countries is to focus their limited resources. They need to identify a particular niche which allows them to address local health needs through biotechnology, then build the necessary infrastructure around that, rather than shooting off in all directions.

For all its political and economic travails, Cuba, for instance, has created an internationally successful biotech sector from its earlier development of an innovative, homegrown vaccine for meningitis. South Africa is spearheading its move into biotech through international collaborations to produce an AIDS vaccine against the type of HIV that hits Africa hardest. The country is also pressing traditional medicine into the service of biotechnology. A molecule isolated by South African scientists from a local succulent (which is traditionally chewed by certain tribes to control hunger and thirst) has been licensed to a British biotechnology firm for development as an anti-obesity treatment.

There is also plenty of scope for poor countries to work with, and learn from, one another. Last month, scientists from 11 Asian countries formed a consortium to study genetic variations in their populations. Farther afield, Heber Biotec, a Cuban operation, is working with Indian and Malaysian companies to manufacture and market its biotechnology products. Rich countries should pay attention, too. Dr Singer argues that donors would do well to consider investing in biotech, and encourage their private firms to establish partnerships with research centres in poorer places, as part of their overseas-aid packages. A few countries, such as Canada and Britain, are placing more emphasis on science in their foreign assistance, but there is room for development. For poor countries, a little biotech could be just what the doctor ordered.

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Genome sequencing

Homespun and cocky

Dec 9th 2004 | BEIJING
From The Economist print edition

China pitches in to sequence two more genomes—silkworm and chicken

Get article background

FOR centuries, the art of silk production was one of China's most closely guarded secrets. Departing travellers were searched, and executed if found to be smuggling silkworm moths, or their eggs, larvae or cocoons. All that is ancient history, of course. Today, China is eager to send its know-how abroad. This week, researchers led by Gane Ka-Shu Wong, of the Beijing Institute of Genomics, have done just that, revealing the genetic blueprint of *Bombyx mori*, the domesticated silkworm, in a paper published in *Science*.

Dr Wong's team also made a significant contribution to the elucidation of the genome of another Asian species, the chicken. This, the first avian genome sequenced, was also announced this week, in *Nature*. Dr Wong and his colleagues were particularly involved in comparing the genome of the wild red jungle fowl of South East Asia, the ancestor of the domestic chicken, with several agricultural varieties.

The sequencing of new genomes is now becoming so commonplace that in one sense it scarcely merits reporting. But the addition of these two to the repertoire is important for two reasons. First, it confirms China's rise to prominence as a power in the world of genomics. Second, it allows biologists to start comparing species from related, but not too closely related, groups of organisms. The line that led to birds separated from the one that led to mammals some 310m years ago. The separation of the moth line from the fly line happened at about the same time.

Not surprisingly, the analyses showed that birds have a lot in common with mammals, such as humans, rats and mice, and moths with flies (of which fruit flies and mosquitoes have been sequenced). The two insect lines, for example, share two-thirds of their genes. What surprised was that some of this commonality, at least in the vertebrates, was in areas not believed to contain any genes. Such areas normally drift in composition, since natural selection cannot “see” them. That suggests these areas have some crucial, but as yet unperceived, function.

There were differences, too, of course. Whole families of genes that were prominent in one line were rare or absent in the other. And chickens had a lot less “junk” DNA than mammals. Or maybe the junk is actually performing some useful function in mammals. More research—and more genomes—are clearly needed...

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Left-handedness

A sinister advantage

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From The Economist print edition

A possible reason why left-handedness is rare but not extinct

IT IS hard to box against a southpaw, as Apollo Creed found out when he fought Rocky Balboa in the first of an interminable series of movies. While “Rocky” is fiction, the strategic advantage of being left-handed in a fight is very real, simply because most right-handed people have little experience of fighting left-handers, but not vice versa. And the same competitive advantage is enjoyed by left-handers in other sports, such as tennis and cricket.

The orthodox view of human handedness is that it is connected to the bilateral specialisation of the brain that has concentrated language-processing functions on the left side of that organ. Because, long ago in the evolutionary past, an ancestor of humans (and all other vertebrate animals) underwent a contortion that twisted its head around 180° relative to its body, the left side of the brain controls the right side of the body, and vice versa. In humans, the left brain (and thus the right body) is usually dominant. And on average, left-handers are smaller and lighter than right-handers. That should put them at an evolutionary disadvantage. Sporting advantage notwithstanding, therefore, the existence of left-handedness poses a problem for biologists. But Charlotte Faurie and Michel Raymond, of the University of Montpellier II, in France, think they know the answer. As they report in the *Proceedings of the Royal Society*, there is a clue in the advantage seen in boxing.

As any schoolboy could tell you, winning fights enhances your status. If, in prehistory, this translated into increased reproductive success, it might have been enough to maintain a certain proportion of left-handers in the population, by balancing the costs of being left-handed with the advantages gained in fighting. If that is true, then there will be a higher proportion of left-handers in societies with higher levels of violence, since the advantages of being left-handed will be enhanced in such societies. Dr Faurie and Dr Raymond set out to test this hypothesis.

Fighting in modern societies often involves the use of technology, notably firearms, that is unlikely to give any advantage to left-handers. So Dr Faurie and Dr Raymond decided to confine their investigation to the proportion of left-handers and the level of violence (by number of homicides) in traditional societies.

By trawling the literature, checking with police departments, and even going out into the field and asking people, the two researchers found that the proportion of left-handers in a traditional society is, indeed, correlated with its homicide rate. One of the highest proportions of left-handers, for example, was found among the Yanomamo of South America. Raiding and warfare are central to Yanomamo culture. The murder rate is 4 per 1,000 inhabitants per year (compared with, for example, 0.068 in New York). And, according to Dr Faurie and Dr Raymond, 22.6% of Yanomamo are left-handed. In contrast, Dioula-speaking people of Burkina Faso in West Africa are virtual pacifists. There are only 0.013 murders per 1,000 inhabitants among them and only 3.4% of the population is left-handed.

While there is no suggestion that left-handed people are more violent than the right-handed, it looks as though they are more successfully violent. Perhaps that helps to explain the double meaning of the word “sinister”.

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Homo floresiensis

Skulduggery

Dec 9th 2004
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The lady vanishes

STRANGE things are afoot in the saga of cousin Florence, the diminutive hominid announced to the world with much brouhaha in October. *Homo floresiensis*, to give the name that science has attached to her skeletal remains and those of six other individuals of the same species found in a cave on the Indonesian island of Flores, excited scientific interest not merely by being a new species of human, but by being one that flourished at the same time as *Homo sapiens*. The most recent of the seven fossils appears to date from a mere 13,000 years ago, well after *Homo sapiens* had passed through Indonesia on its way to Australia. But that, and other facts concerning the discovery, may now be hard to confirm because most of the remains have been borrowed by Teuku Jacob, a researcher at Gadjah Mada University in Jogjakarta, who was not involved in the original excavation.

This is rather irregular behaviour, and seems to contradict an agreement between the Indonesian and Australian institutions involved in the dig (the Centre for Archaeology in Jakarta, and the University of New England, in New South Wales) that the remains would be kept at the Centre for Archaeology, and made available for study by outside researchers. It might, however, not be anything to worry about if it were not for the fact that Dr Jacob, a doyen of Indonesian palaeoanthropology, has a reputation for sitting on specimens and preventing others from examining them. In the case of *Homo floresiensis*, it seems he was miffed that he was not involved in the original project, even though the idea of digging in Flores was not to find new species, but rather to look for evidence of exactly how and when humanity first arrived in Australia. Hence the involvement of Australian researchers. However, since Florence's existence was announced in a paper in *Nature*, he has been trying to get in on the act.

First, he wrote a piece for *Nature*'s rival *Science*, suggesting that the skeleton was merely a diminished—possibly diseased—version of *Homo sapiens*, rather than a genuinely new species. That was despite the fact that many of its features are completely different from those of modern humans. Then he removed the original specimen that was the subject of the *Nature* paper. Now, he has taken most of the rest of the material—dramatically stuffing the bones into a leather case with the assistance of Radien Soejono, a researcher at the Centre for Archaeology who was one of the authors of the paper in *Nature*, but apparently without the permission of the centre's director, Tony Djubiantono.

Dr Jacob says he will return the fossils by the beginning of January. If he does so, and they have not been damaged by their undignified treatment, then the incident will have turned out to be a storm in a teacup. But if not, then the case of *Homo floresiensis* risks becoming like that of the Dead Sea scrolls, which were kept in purdah for years by a group of academics who would neither publish their findings, nor allow anyone else to examine them.

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Leonardo da Vinci

A heretical mind

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From The Economist print edition

Bridgeman

The Renaissance master's "strange career"

TWO new books on Leonardo da Vinci have covers that are almost identical. Both authors have pored over Leonardo's notebooks, and claim to take us inside the mind of the Renaissance giant. Yet one book, a surprisingly short one, paints Leonardo as a genius, whereas the other, a doorstep of a volume, presents him uncut, looking something of a fallen angel. Which Leonardo you choose depends on whether you prefer your heroes on or off their pedestal.

Martin Kemp, an eminent Oxford art historian and Leonardo scholar, has condensed what he calls Leonardo's "strange career" as an artist, engineer and musician into a series of key moments. Writing his book in the Tuscan villa that was once home to a smiling housewife named Lisa, thought to be the model for the most famous painting in the world, Mr Kemp warms to the ambience of the place before launching into the essential facts about the man. Yet after an auspicious beginning, the book reads like a gallery guide to Leonardo, and this may be because Mr Kemp is organising a Europe-wide exhibition of Leonardo in 2006, called the Universal Leonardo Project. His is a convenient handbook for the show or for any of the 24 paintings he attributes to the artist, and the book is also worth buying for Mr Kemp's handy timeline and illustrated list of Leonardos at the back. The prose, however, is more efficient than uplifting.

Charles Nicholl's long biography of the master is more gratifying to read, yet it ties itself in knots trying to follow every lead that Leonardo, his contemporaries and a legion of scholars have left behind. The author's goal is to show not the genius but rather the man, and he does his best to drag Leonardo down to earth. He begins with an anecdote about a note of Leonardo's jotted in the margins of an exposition on geometry: he is stopping work, the note explains, because his soup is getting cold. More details follow about Leonardo's animal-loving vegetarianism and about his inability to get a job done on time. A Freudian analysis of Leonardo's paintings of the Holy Family attempts to expose the artist's problems with father figures (Joseph is always absent, you see). And you learn

Leonardo
By Martin Kemp

Oxford University Press; 286 pages; $26 and £14.99

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Amazon.com
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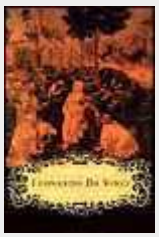
Leonard da Vinci: The Flights of the Mind
By Charles Nicholl



Viking Books; 622 pages; $28.95

more perhaps than you might wish about the homoerotic impulses in Leonardo's angels. That Leonardo, like Michelangelo and Botticelli, was homosexual is not news, but the lurid details of his love life may surprise some.

Penguin/Allen Lane; £25

Buy it at
Amazon.com
Amazon.co.uk

Such information would be more enlightening if it informed an analysis of how Leonardo became the great creative thinker we now consider him to be. Yet the only clues about the development of Leonardo's exceptional mind come from the fact that he was the illegitimate son of a notary; as such, he was not allowed to follow in the family business and was therefore spared a rigid education.

Instead, he was sent with his mother to live on a Tuscan farm. There, a deep love for nature was fostered, while his mind was able to develop, unfettered to an unusual degree. Leonardo was then apprenticed to a Florentine artist, Verrocchio, at a time when many artists were interested in the fashionable new techniques of perspective and oil painting.

According to both books, Leonardo's fascination with engineering came from watching the construction of Brunelleschi's vast dome over the cathedral in Florence. Yet other young artists who worked in Medici Florence had also turned their hands to everything, from painting to architecture and interior decoration. So what was special about Leonardo?

First, as Giorgio Vasari said in the 16th century, Leonardo had a “heretical” state of mind. So great was his curiosity about how things worked that he would believe only what had been proved empirically before his eyes. The clandestine dissections that got him in trouble with the pope flowed logically from a desire to learn how the body worked, the better to be able to render it in art.

Second, Leonardo was obsessed with birds, and claimed that his first memory was of being visited by a red kite in his cradle. Mr Nicholl constructs intricate theories about this, finding hidden bird patterns in the folds of the skirt of the “Madonna of the Rocks”, among other places.

Mr Nicholl's book brings the reader no closer to the nature of Leonardo's genius, though a better understanding of the man, warts and all, does emerge—a subtler appreciation of a man, for instance, who devised war machines for the violent Cesare Borgia yet also bought caged birds to set them free. Leonardo's love of birds and his desire to “conquer the resistance of the air” is the lasting and original detail of this book. Metaphorically, Leonardo flew, because he was for ever asking why.

Leonardo.
By Martin Kemp.
Oxford University Press; 286 pages; $26 and £14.99

Leonard da Vinci: The Flights of the Mind.
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About sponsorship

Fra Carnevale

Still enigmatic

Dec 9th 2004 | MILAN
From The Economist print edition

Found: one old master

LOST Renaissance masterpieces turn up now and then: only in October, the painted banner of a religious fellowship was freshly attributed to Raphael. But a lost Renaissance master? An exhibition at the Brera gallery in Milan, which transfers to New York's Metropolitan Museum on February 1st, proposes just that.

Two of the finest works of the 15th century, panels from the so-called Barberini altarpiece, have long lacked firm attribution. Now, the exhibition catalogue publishes documents that show fairly conclusively that the panels are by the hand of Bartolomeo di Giovanni Corradini, a painter who became Fra Carnevale when he entered the Dominican order in the 1440s.

Carnevale is known to have helped Filippo Lippi in Florence. He then returned to his native Urbino where he was a leading figure at the court of the city's enlightened ruler, Federico di Montefeltro; he died in 1484. One of the show's curators, Matteo Ceriana, argues that Carnevale is a higher artist even than Botticelli.

For centuries, almost the only trace of Carnevale's existence was a reference in Giorgio Vasari's “The Lives of the Artists”. Vasari said Carnevale was an early influence on Bramante, the architect of St Peter's in Rome, and that he painted the altarpiece of the church of Santa Maria della Bella in Urbino. Yet when scholars began looking for this masterpiece, it had vanished.

As early as 1893, it was suggested that two panels depicting scenes from the life of the Virgin, then in the palace of the Barberini family in Rome, might be from the missing altarpiece. Recently that suspicion has grown, and it has now been put beyond doubt. Papers that emerged only last June chronicle how in 1632 the altarpiece was dismantled and taken by mule to Rome, on the orders of Antonio Barberini, then papal legate in Urbino. In 1935 they were sold and now hang in New York and Boston. They have been reunited for the Milan exhibition.

The Barberini panels are exceptional works, with a vibrant use of colour, architectural inventiveness and a keen understanding of perspective. But do these qualities bring Carnevale to the front rank?

Another of the curators, Keith Christiansen, thinks not. “Carnevale is not one of the presiding geniuses of the *quattrocento*. But he is a crucial figure for the transmission of the Renaissance to Urbino”—a city that produced not just Bramante, but also Piero della Francesca and Raphael.

The Milan show includes every work confidently attributed to Fra Carnevale. There are only nine. To stimulate discussion that might lead to more attributions, the curators have hung several other disputed works. Research for the exhibition has also unearthed leads to further possible Carnevales, including talk of one that hangs in a private Polish collection.

Many mysteries still surround this most enigmatic of Renaissance geniuses. Does anything survive from Carnevale's youth? Since his last known work dates from the early 1470s, what did he do in the final decade of his life? And why did he call himself Brother Carnival in the first place?

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About sponsorship

The papacy

For God's sake

Dec 9th 2004
From The Economist print edition

Get article background

JOHN CORNWELL, author of a new life of Pope John Paul II, would have made a fine devil's advocate when the pope's name is one day advanced for sainthood. Unfortunately, he will not be chosen, for John Paul II himself, some two decades ago, scrapped the custom of having a devout Catholic question the virtues of a candidate for beatification or canonisation. The old job of devil's advocate is now, in effect, performed by committee.

Devil's advocates were supposed to be fair-minded, and in the past Mr Cornwell, a prolific writer on Catholic matters, has at times been anything but. As he admits, "Hitler's Pope" (1999), his biography of Pope Pius XII, lacked balance. "I would now argue," he says, "in the light of the debates and evidence following 'Hitler's Pope', that Pius XII had so little scope of action that it is impossible to judge the motives for his silence during the war, while Rome was under the heel of Mussolini and later occupied by the Germans."

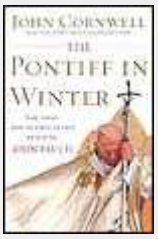
Chastened by this experience, Mr Cornwell is now a better biographer. In this life of John Paul II, he celebrates his subject's achievements as well as deploring the mistakes. The pope's heroism is affirmed. As a young would-be priest in occupied Poland, Karol Wojtyla was not intimidated by Nazi efforts to liquidate the Catholic clergy. A priest under Communism, he was again courageous. When the Soviet system imploded, "few would dispute that the inexorable and bloodless process had been initiated by the Polish pope."

Unfortunately, as Mr Cornwell sees it, the siege mentality that enabled Polish Catholics to survive persecution has carried over into John Paul II's papacy. The pope presents himself as a reformist in the spirit of the Second Vatican Council, and indeed he reveals himself as such in many things—in "liturgy, focus on scripture, outreach to the world, compassion for the poor and disenfranchised." Overall, though, John Paul II is an authoritarian rather than a collegial pope, Mr Cornwell says. He has centralised power in the Vatican where, in his dotage, it is increasingly exercised by reactionary cardinals.

Here the biographer almost gives way to despair. The astonishing feature of John Paul's campaign against condoms has been the lack of public dissent by the bishops, even though many bishops privately disagree with the pope. The same, the author complains, goes for the pope's stands on married clergy, homosexuality and women priests, and for his willingness to meet such sinners as George Bush (whose re-election chances were perhaps boosted) and Tariq Aziz, then Saddam Hussein's deputy (thereby validating a deeply nasty regime). And by resolutely strengthening the centre during his papacy, Mr Cornwell says, John Paul II has demoralised the periphery into sullen silence.

In referring to the "periphery", Mr Cornwell overreaches himself. He is really interested only in those of the world's 1 billion Catholics who are liberal westerners like himself. John Allen, an admirably objective American journalist, has a broader perspective. The pope, he notes, has to ponder not just how something will play in Peoria, but also in Pretoria, Beijing and São Paulo. Westerners, especially Americans, he notes, often want to do things in their own way, and see opposition from Rome as a form

The Pontiff in Winter: Triumph and Conflict in the Reign of John Paul II
By John Cornwell



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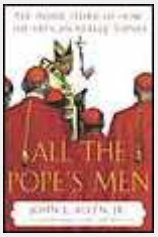
By John Allen



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of oppression. But from Rome's point of view it often seems the reverse—it is saving the rest of the church from being involuntarily “Americanised”.

Like John Paul II, members of the Curia, the Vatican bureaucracy, strive to “think in centuries”. They believe that the Catholic church will still be around when Communism and Nazism are footnotes in history books and when George Bush and Tariq Aziz and even John Paul II are forgotten. They accept reform, but usually only after thinking about it long and hard. Mr Cornwell's despair is premature.

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Children's books

A world of wonder

Dec 9th 2004
From The Economist print edition

The pick of the crop

BOOKSHOPS are piled higher than ever with lavishly illustrated children's books tricked out to look like instant classics. What to buy? *The Economist* offers its own selection of new titles for children of all ages.

Five years old and under

Whether to be read alone or to be read aloud, a good picture book for young children strikes a balance between words, which must not be too plentiful, and images, which must not shout too loudly. "How Many Miles to Bethlehem?" (Scholastic, $16.95 and Orion, £9.99), is a deft re-telling of the story of the Nativity by an English poet, Kevin Crossley-Holland, with Peter Malone as illustrator. The words are spare and well chosen (every actor in the drama, from the ass to the angel, has a page to present his point of view), while the rich pictures are almost Giotto-like in atmosphere and choice of detail.

Also ringing the changes on a seasonal theme is "Santa's Littlest Helper" (Bloomsbury, $15.95 and £9.99), a collaboration between Anu Stohner and Henrike Wilson as illustrator. One of Santa's undervalued assistants stumbles upon a startling fact: animals, unlike children, don't usually get presents.

Alexis Deacon is one of the finest of a younger generation of English illustrators for children. In his third work, "Jitterbug Jam: A Monster Tale" (Hutchinson, £10.99; to be published in America by Farrar, Straus and Giroux in March), Mr Deacon collaborates with an American writer, Barbara Jean Hicks, to produce a gentle morality tale about the nature of strangeness. His horned monsters, alarming to look at but gentle in character, seem distantly related to Maurice Sendak's wild things.

The best animal picture book of the season is "Lord of the Forest" (Frances Lincoln, $16.95 and £10.99) by Caroline Pitcher and Jackie Morris. Ms Morris's illustrations are lavish and painterly, and the story—who exactly is the king of the jungle?—holds the reader in suspense until the very last page.

The funniest new picture book is Posy Simmonds's "Baker Cat" (Jonathan Cape, £10.99), the tale of a baker's cat who manages to outwit his owner, a thoroughly punitive and miserable fellow, by forging a cunning alliance with the very mice he is supposed to be keeping out of the bakery. Children will adore the fussy detail and the hilarious dialogue.

New in Britain, "The King of Capri" (Bloomsbury, $16.95 and £4.99) is a tale by Jeanette Winterson, who is better known for her novels for grown-ups; it is illustrated with panache by Jane Ray. The wind blows away the clothes of a greedy king, but they land on the roof of a tender-hearted woman. The story has all the ease and surprise of an old folk tale.

Six- to ten-year-olds

Two new editions of classic books head the list for children at the younger end of this age range. Naomi Lewis has produced an excellent new selection from the "Tales of Hans Christian Andersen" (Candlewick Press, $22.99 and Walker Books, £14.99). All the favourites are here, from "Thumbelina" to "The Little Mermaid" and "The Emperor's New Clothes", along with lesser known stories, such as "The Flying Trunk". Joel Stewart's illustrations bring out the many moods in Andersen's stories—their darkness, their vertigo-inducing strangeness, their wild flights of humour.

From the same publishers comes Martin Jenkins's sensitive abridgement of Jonathan Swift's "Gulliver" (Walker Books, £14.99; to be published in America by Candlewick Press in March). The illustrations of Chris Riddell, formerly with *The Economist*, show his characteristic flights of fancy.

Admirers of Philip Pullman for his "Dark Materials" trilogy will be pleased to discover that he is no less adept at writing fantasy for younger children. "The Scarecrow and His Servant" (Doubleday, £10.99; to be published in America by Knopf next August) has familiar elements of plot and characterisation, from the perky and comical scarecrow himself to the serendipitous journey he takes in the company of a small, hungry boy called Jack. Yet the familiar is transformed by the engaging and unpredictable way in which the story unfolds. Sheer delight.

"Magical Children" (Dolphin Paperbacks, £7.99) brings together three short novels by Sally Gardner about children who have magical gifts—the strongest girl in the world, a boy who can fly and another who just happens to be invisible. Ms Gardner's strength lies in her ability to combine the extraordinary with the utterly unexceptional.

"Christopher Mouse: The Tale of a Small Traveller" (Bloomsbury, $15.95 and £9.99) is a wonderful first novel by William Wise for readers with growing confidence. It is about the adventures of a mouse who moves from family to family and—after much travel and heartache—finds a happy home. The delight of this book is in the deft humour of the first-person storytelling.

Two novels not to be missed at the upper end of the age range are Linda Newbery's "At the Firefly Gate" (Orion, £7.99) and Shannon Hale's "Enna Burning" (Bloomsbury, $17.95 and £12.99). The first is about an unconfident urban boy, newly displaced to rural Suffolk, who makes strangely magical links across the generations. The second is an historical fantasy which circles around the mysteries of fire.

Eleven and above

Children's fiction for this age group has long been dominated by fantasy published in series. This season two authors with an excellent record have new titles to their name. Herbie Brennan adds to his "Faerie Wars" series with a new book, "The Purple Emperor" (Bloomsbury, $17.95 and £12.99). In it, a son has the unenviable task of following in the footsteps of a father who has returned from the grave. Mr Brennan's manner is both brisk and amusing.

Paul Stewart and Chris Riddell have again collaborated on the latest novel—the seventh—in the "Edge Chronicles" series. "Freeglader" (Doubleday, £12.99) is set in foot-slogging, mist-choked Tolkien/Pratchett country. A young knight-librarian, Rook Barkwater, inches his way through peril, meeting ferocious birds, treacherous blowholes and bogs, and much else to keep him on his mettle.

Ursula Le Guin is a distinguished author of fantasies for older children. Her new novel, "Gifts" (Harcourt, $17 and Orion, £10.99), feels rooted in the folk tales of some distant, mythic tribe. The intricate plot is plainly yet absorbingly written.

Frank Cottrell Boyce has written a delightful and quirky thriller, set in Ireland just before the introduction of the euro. "Millions" (HarperCollins, $15.99 and Macmillan, £5.99) is quite unlike anything else recently written for this age group. The narrator, Anthony Cunningham of Year Six, has a direct and beguiling voice: funny, odd and compulsively readable. This is a story about money—how it arrives out of the blue, and how it needs to be to spent, fast.

More poignant and inward-looking is "Private Peaceful" (Scholastic, $16.95 and Collins, £5.99), a novel by Michael Morpurgo, Britain's children's laureate. A young private, trapped in the trenches during the first world war, reflects upon his peaceful rural childhood. The closer danger creeps, the more he faces backwards into the past to retrieve some sense of inner tranquillity.

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Le petit Nicolas

He's back

Dec 9th 2004 | PARIS
From The Economist print edition

Uncovered: a horde of words and pictures

WHEN Anne Goscinny moved house four years ago, she unearthed a big box that must have belonged to her late father, René Goscinny, probably France's best-known author of cartoons and illustrated stories. The box contained hundreds of pages of stories about le petit Nicolas, a little-schoolboy character created in the 1950s by Mr Goscinny and the illustrator Jean-Jacques Sempé. Delighted to be able to indulge in childhood memories, Ms Goscinny settled down for a nostalgic read. After a couple of pages she discovered something else: she had not read these stories before.

Ms Goscinny had assumed that the five existing volumes of "The Chronicles of Little Nicholas" were the entire legacy of the creative friendship between her father and Mr Sempé. Between 1959 and 1965 the stories were serialised in *Sud-Ouest Dimanche*, a regional newspaper, and when they were first published in book form in 1961 they became instant bestsellers. Le petit Nicolas stories have sold 8m copies in more than 30 languages.

Nicolas tells readers about life in his words. He likes football, ice cream, holidays and, most of all, his friends. There is his best friend, Alceste, who eats all the time; Rufus, who has a whistle because his father is a policeman; sweet Marie-Edwige, whom Nicolas wants to marry when he is big; and Clotaire, Eudes, Geoffroy and Agnan. The world of Nicolas is happy and reassuring. A parental dispute ends with the family munching apple pie. When Nicolas and his friends scuffle, nobody is hurt. "It is an ideal of a child's world," Ms Goscinny says.

With Mr Sempé's blessing, Ms Goscinny and her husband set up a publishing house, called IMAV, to make a book out of the 80 rediscovered stories. The 600-page volume, "Histoires inédites du Petit Nicolas", has become an instant hit, selling 250,000 copies since its publication in October. On December 6th hundreds of people snaked around the Virgin Megastore building on the Champs-Elysées in Paris to have their book signed by Mr Sempé.

The overwhelming success of the unpublished stories takes Ms Goscinny aback somewhat. After all, she says, the vocabulary is dated, while no modern-day Alceste would boast about his papa installing a telephone at home. But it is parents and grandparents who buy the book. Sitting down with it, they enjoy the memory of their own childhood. And when they do agree to pass the book along to children, these too seem to be won over by the stories' timeless charm.

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Obituary

Alicia Markova

Dec 9th 2004
From The Economist print edition

Getty Images

Alicia Markova, born Alice Marks, prima ballerina assoluta, died on December 2nd, aged 94

THE story of Giselle is a simple one. A country girl falls for a prince who has come to her village in disguise. When she finds that her Albrecht is a *poseur*, actually betrothed to a princess, she goes mad and dies. He visits her grave, penitent. Giselle, now a spirit, is commanded by the queen of the spirits to lure Albrecht to death by her dancing; instead, she rescues him before returning to her grave.

It is all in the best early 19th-century German Romantic taste: jovial peasants, gloomy forests, simpering maidens dancing in a line, and a dreadfully sentimental score. Or so it appeared to Alicia Markova when, at 18, she began to hear suggestions that she should dance the role. The world, surely, had moved on since then.

She herself had embraced a style of ballet utterly removed from organza and *pas de deux*. Since being taken up by Serge Diaghilev, who had spotted her in 1924 as a waif-like child at her Chelsea dancing class, she had been at the cutting-edge of the modern movement. She had worn a daring white leotard, covered with squiggles drawn on personally by Matisse, to dance the title role in Stravinsky's “Le Rossignol”, and had learned, under Stravinsky's direction, to move to melody rather than beats. The world of the 1920s was cynical and syncopated, the ballet full of athleticism, primitivism and jazz. It had no room, surely, for the sugary old melodramas of Gaultier and Heine.

Nonetheless, Diaghilev—“Sergi-pop”, as she called him—had planned a Giselle for her before he died, in 1929. And in 1932, as she assisted Olga Spessivtseva, who was dancing the role, Miss Markova felt her attitude changing. Sitting on a chair in the wings, she began by simply scrutinising the diva's footwork; but by the end of Act 1, she found herself in tears. She had never dreamt that so much emotion could be combined with the strictness of classical dancing. As she wrote later, still surprised, “I had not been schooled in this.”

From that moment, Giselle was her role, danced almost constantly until she retired in 1963. It was one that particularly suited her, combining steely strength with ethereal grace. For much of the second act she seemed to float and fly, as if the air was her natural element. Sometimes her leading men (usually Anton Dolin, with whom she was supposed to have been secretly in love) appeared to have trouble

bringing her to earth again. Yet the multiple *fouettés* of the second act were exhausting, and the double-turning jumps were something no woman had done before her. Her dancing was all the more extraordinary because, as a child, she had been so knock-kneed and flat-footed that doctors predicted she would spend her life in leg-irons.

Yet Giselle was still a rather creaky, old-fashioned vehicle for a woman who was also, at the same time, wildly dancing the Polka in Walton's “Façade” and cavorting in a body-suit in Stravinsky's “Rouge et Noir”. She was often asked why it was so important to her. In her small, careful voice she would explain that Giselle was “the fullest single expression of what can be said in terms of the dance”. It was her duty, she felt, to keep the beauty of that character alive through her own.

Leaving her wings

It was also her duty to bring classical ballet to audiences in Britain and America that had lost touch with it, or had never known it. Dance in the early 20th century was a Russo-French monopoly; plain Alice Marks had been rechristened “Markova” by Diaghilev because a dancer with a British name would not be taken seriously. This she resolved to change, and Giselle was her means to do it.

The role was a central feature of the seasons she helped arrange in the 1930s and 1940s at the Ballet Rambert and the Vic-Wells Ballet (later the Royal Ballet), both ensembles newly formed to cater for the masses. She danced it not only at the Old Vic and the New York Met but at a greyhound-racing stadium in London, where, in the interval, the balletomanes queued for hot dogs and orangeade. Once she left her wings in a cab; the driver happily returned them to “the dancer wot flies”.

Over the years, her personality and Giselle's became inseparable in the public mind. Her fans were certain that, when analysing Giselle in her book, “Giselle and I”, she was describing herself:

> She is quiet, yet inflexible in her loves and loyalties, sensitive, yet with an innate simplicity. Always she stands a little apart from her exotic colleagues, the great ladies of Ballet's fairyland, scarcely venturing into this regal Court of Stars, though in one sense she is Queen of them all.

In reality, the simple village girl was on $1,000 a week, and able to negotiate such fees with merciless hard-headedness. Rather than favouring peasant skirts and wreaths of woodland flowers, her tastes ran to full-length mink coats and Ferragamo shoes. The onstage wraith would fall on steaks and chocolates as soon as the curtain had descended. But there was always a china-cool remoteness and independence about her—and absolutely no doubt, until Margot Fonteyn's star began to rise, that she was queen of them all.

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About sponsorship

Correction: General Rafael Eitan

Dec 9th 2004

Our obituary last week of General Rafael Eitan claimed that he had run Jonathan Pollard as Israel's spy in Washington. In fact, Mr Pollard was run by a different Rafael Eitan, a former Mossad operator. Fooled us, too.

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Overview

Dec 9th 2004
From The Economist print edition

The **euro** continued to strengthen against the dollar and reached a high, above $1.34, before weakening slightly. **Sterling** hit a 12-year high against the greenback of $1.95.

America's labour market confounded expectations again. In November, the American economy added 112,000 new jobs, against forecasts of around 200,000. The estimates of new jobs gained in September and October were revised down by 54,000. The unemployment rate, however, fell to 5.4% in November from 5.5% in October. The Institute for Supply Management's index of service-sector activity rose to 61.3, a level that indicates strong growth.

Canada's economy also produced fewer jobs than expected in November: only 4,600, compared with forecasts of 25,000.

Switzerland's GDP rose by 1.8% in the year to the third quarter, compared with 1.9% in the year to the second quarter.

Japan's economy grew by a revised 2.6% in the year to the third quarter, compared with the previous estimate of 3.9%.

Britain's industrial production fell unexpectedly by 0.1% in October, the fifth monthly decline in a row. In the year to October, industrial output fell by 1.9%.

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Output, demand and jobs

Dec 9th 2004
From The Economist print edition

% change on year ago

	GDP latest		GDP qtr*	The Economist poll GDP forecasts 2004	2005	Industrial production latest		Retail sales (volume) latest		Unemployment % rate latest		year ago
Australia	+ 3.0	Q3	+ 1.2	+ 3.6	+ 3.1	+ 4.6	Q2	+ 5.7	Q3	5.2	Nov	5.7
Austria	+ 1.8	Q2	+ 3.5	+ 1.7	+ 2.1	+ 6.5	Sep	+ 3.2	Aug	4.5	Oct	4.6
Belgium	+ 3.0	Q3	+ 3.2	+ 2.5	+ 2.1	+ 3.2	Oct	+ 2.7	Sep	12.8	Nov†	12.5
Britain	+ 3.0	Q3	+ 1.5	+ 3.2	+ 2.4	– 1.9	Oct	+ 6.0	Oct	4.6	Sep††	5.0
Canada	+ 3.3	Q3	+ 3.2	+ 2.9	+ 3.1	+ 3.8	Sep	+ 3.6	Aug	7.3	Nov	7.5
Denmark	+ 1.9	Q3	+ 0.2	+ 2.2	+ 2.2	– 3.3	Oct	+ 6.5	Oct	6.3	Sep	6.3
France	+ 2.0	Q3	+ 0.3	+ 2.2	+ 1.9	+ 2.9	Sep	+ 1.0	Aug	9.9	Oct	9.9
Germany	+ 1.3	Q3	+ 0.4	+ 1.4	+ 1.4	+ 3.8	Sep	– 2.6	Oct	10.8	Nov§	10.5
Italy	+ 1.3	Q3	+ 1.7	+ 1.2	+ 1.5	+ 0.8	Sep	– 4.0	Aug	8.1	Apr	8.7
Japan	+ 2.6	Q3	+ 0.2	+ 3.9	+ 1.9	– 1.1	Oct	– 0.4	Sep	4.7	Oct	5.2
Netherlands	+ 1.4	Q3	+ 0.8	+ 1.2	+ 1.3	+ 0.3	Oct	– 0.1	Aug‡	6.3	Oct**	5.4
Spain	+ 2.6	Q3	+ 2.4	+ 2.6	+ 2.5	– 7.0	Oct	+ 0.2	Sep	10.5	Oct	11.2
Sweden	+ 3.6	Q2	+ 4.0	+ 3.4	+ 2.8	+ 5.3	Sep	+ 3.5	Oct	4.9	Oct†	5.1
Switzerland	+ 1.8	Q3	+ 1.4	+ 1.8	+ 1.8	+ 4.3	Q2	– 0.3	Sep	3.9	Nov†	4.0
United States	+ 4.0	Q3	+ 3.9	+ 4.4	+ 3.5	+ 5.2	Oct	+ 5.2	Oct	5.4	Nov	5.9
Euro area	+ 1.8	Q3	+ 1.2	+ 1.8	+ 1.7	+ 2.9	Sep	– 0.2	Oct	8.9	Oct	8.9
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*											
Finland	+ 3.2	Q3	+ 4.3	na	na	+ 7.0	Oct	+ 4.9	Sep	8.0	Oct†	8.3
Greece	+ 3.9	Q2	– 0.6	na	na	+ 0.8	Sep	+ 6.6	Jul	na		na
Iceland	+ 6.2	Q2	na	na	na	na		na		2.6	Sep†	2.7
Ireland	+ 4.1	Q2	na	na	na	+ 5.2	Sep	+ 3.2	Sep	4.3	Nov	4.5
Luxembourg	+ 2.1	2003	na	na	na	– 1.2	Dec	– 8.2	Sep	4.3	Oct	4.0
New Zealand	+ 6.0	Q2	+ 4.6	na	na	+ 5.5	Q2	+ 7.4	Q3	3.8	Q3	4.4
Norway	+ 4.1	Q2	+ 5.0	na	na	– 3.3	Sep	+ 2.4	Oct	3.5	Nov‡	3.7
Portugal	+ 1.5	Q2	+ 4.7	na	na	– 7.8	Oct	+ 3.6	Sep	6.8	Q3†	6.1

*% change on previous quarter at an annual rate. †Not seasonally adjusted. ‡New series. ††Jul-Sep; claimant count rate 2.7% in Oct. §EU harmonised rate 9.9% in Oct. **Aug-Oct.

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Prices and wages

Dec 9th 2004
From The Economist print edition

% change on year ago

	Consumer prices			The Economist poll consumer prices forecast		Producer prices			Wages/earnings		
	latest		year ago	2004	2005	latest		year ago	latest		year ago
Australia	+ 2.3	Q3	+ 2.6	+ 2.4	+ 2.5	+ 6.1	Q3	– 0.1	+ 3.7	Q3	+ 5.1
Austria	+ 2.6	Oct	+ 1.0	+ 1.9	+ 1.7	+ 6.0	Oct	+ 2.0	+ 2.0	Sep	+ 2.3
Belgium	+ 2.5	Nov	+ 1.9	+ 2.0	+ 1.7	+ 6.0	Oct	– 1.0	+ 2.2	Jul	+ 1.9
Britain	+ 1.2	Oct*	+ 1.4	+ 1.5	+ 1.7	+ 3.5	Oct	+ 1.5	+ 3.7	Sep†	+ 3.6
Canada	+ 2.3	Oct	+ 1.6	+ 1.9	+ 2.1	+ 5.4	Oct	– 4.0	+ 2.2	Aug	+ 3.5
Denmark	+ 1.7	Oct	+ 1.4	+ 1.2	+ 1.7	+ 3.6	Oct	nil	+ 2.9	Q3	+ 3.7
France	+ 2.1	Oct	+ 2.2	+ 2.2	+ 1.6	+ 3.5	Oct	+ 0.3	+ 2.7	Q3	+ 2.9
Germany	+ 1.8	Nov	+ 1.3	+ 1.8	+ 1.4	+ 4.2	Oct	+ 0.6	+ 0.9	Sep	+ 2.6
Italy	+ 2.0	Nov	+ 2.5	+ 2.3	+ 2.0	+ 4.4	Oct	+ 0.7	+ 2.7	Oct	+ 2.6
Japan	+ 0.5	Oct	nil	– 0.1	nil	+ 1.9	Oct	– 0.5	– 0.2	Oct	+ 2.1
Netherlands	+ 1.4	Oct	+ 2.0	+ 1.4	+ 1.2	+ 6.9	Oct	– 0.2	+ 1.0	Nov	+ 2.4
Spain	+ 3.6	Oct	+ 2.7	+ 3.0	+ 2.8	+ 5.4	Oct	+ 0.6	+ 3.1	Q2	+ 4.2
Sweden	+ 0.8	Oct	+ 1.4	+ 0.7	+ 1.6	+ 3.0	Oct	– 1.9	+ 2.2	Aug	+ 3.3
Switzerland	+ 1.5	Nov	+ 0.5	+ 0.8	+ 1.2	+ 2.0	Oct	– 0.3	+ 1.4	2003	+ 1.8
United States	+ 3.2	Oct	+ 2.0	+ 2.7	+ 2.3	+ 4.4	Oct	+ 3.9	+ 2.4	Nov	+ 2.2
Euro area	+ 2.2	Nov	+ 2.2	+ 2.1	+ 1.8	+ 4.0	Oct	+ 0.8	+ 2.1	Q2	+ 3.3
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*										
Finland	+ 0.9	Oct	+ 0.3	na	na	+ 3.0	Oct	– 0.9	+ 3.1	Q3	+ 4.3
Greece	+ 3.2	Oct	+ 3.2	na	na	+ 2.7	Sep	+ 1.5	na		na
Iceland	+ 3.8	Nov	+ 2.5	na	na	+ 6.1	Nov	+ 3.3	+ 5.3	Oct	+ 5.5
Ireland	+ 2.7	Oct	+ 2.3	na	na	– 0.4	Oct	– 8.4	+ 3.8	Q2	+ 8.0
Luxembourg	+ 2.4	Nov	+ 1.8	na	na	+15.0	Sep	+ 0.5	– 0.4	Dec	+ 0.7
New Zealand	+ 2.5	Q3	+ 1.5	na	na	+ 2.5	Q3	+ 0.1	+ 2.2	Q3	+ 2.3
Norway	+ 1.4	Oct	+ 1.6	na	na	+24.1	Oct	+ 2.1	+ 4.6	Q3	+ 4.2
Portugal	+ 2.1	Oct	+ 3.0	na	na	+ 5.2	Oct	– 0.8	+ 1.4	Sep	– 1.8

*New series. RPI inflation rate 3.3% in Oct. †Jul-Sep.

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Economic forecasts

Dec 9th 2004
From The Economist print edition

The Economist poll of forecasters, December averages (previous month's, if changed)

	Real GDP, % change Low/high range		Real GDP, % change average		Consumer prices % increase		Current account % of GDP	
	2004	2005	2004	2005	2004	2005	2004	2005
Australia	3.4/4.4	2.5/3.5	3.6	3.1 (3.2)	2.4 (2.5)	2.5 (2.7)	−5.9(−5.8)	−5.4 (−5.3)
Austria	1.0/2.0	1.5/2.4	1.7 (1.6)	2.1	1.9 (1.7)	1.7 (1.6)	−0.5(−0.3)	−0.6 (−0.4)
Belgium	1.8/2.7	1.6/2.5	2.5 (2.4)	2.1	2.0	1.7 (1.8)	3.2 (3.3)	3.2
Britain	3.1/3.3	1.9/3.2	3.2	2.4 (2.5)	1.5 (1.4)	1.7	−2.5	−2.7
Canada	2.7/3.0	2.6/3.6	2.9 (3.0)	3.1 (3.3)	1.9 (2.0)	2.1 (2.2)	2.7 (2.8)	2.3 (2.5)
Denmark	2.0/2.6	1.8/2.6	2.2 (2.3)	2.2 (2.3)	1.2	1.7 (1.8)	3.0 (2.9)	2.6
France	2.0/2.5	1.3/2.2	2.2 (2.4)	1.9 (2.2)	2.2 (2.3)	1.6 (1.7)	0.2 (0.3)	0.2 (0.3)
Germany	1.2/1.7	1.0/2.0	1.4 (1.5)	1.4 (1.6)	1.8	1.4	3.3 (3.2)	3.1 (2.9)
Italy	1.0/1.3	0.9/1.8	1.2 (1.1)	1.5 (1.6)	2.3	2.0 (2.1)	−0.9	−1.0 (−1.1)
Japan	2.1/4.3	0.5/2.6	3.9 (4.3)	1.9 (2.1)	−0.1	nil (0.1)	3.5	3.4 (3.5)
Netherlands	1.0/1.4	1.0/2.0	1.2	1.3 (1.6)	1.4	1.2 (1.3)	2.9	3.0
Spain	2.5/2.8	2.0/3.0	2.6	2.5	3.0 (2.9)	2.8	−3.3(−3.4)	−3.6
Sweden	3.0/3.8	2.3/3.1	3.4	2.8 (2.9)	0.7	1.6	7.3 (7.0)	6.6 (6.4)
Switzerland	1.2/2.0	1.3/2.1	1.8	1.8 (2.0)	0.8 (0.7)	1.2 (1.1)	11.7(11.3)	11.2 (10.8)
United States	4.3/4.5	3.0/4.0	4.4	3.5 (3.4)	2.7 (2.6)	2.3	−5.5	−5.6 (−5.4)
Euro area	1.6/2.0	1.4/2.2	1.8	1.7 (1.9)	2.1	1.8	0.5 (0.6)	0.5 (0.6)

Sources: ABN Amro, Deutsche Bank, Economist Intelligence Unit, Goldman Sachs, HSBC Securities, KBC Bank, J.P. Morgan Chase, Morgan Stanley, Decision Economics, BNP Paribas, Royal Bank of Canada, Citigroup, Scotiabank, UBS

Every month, *The Economist* surveys a group of forecasters and calculates the average of their predictions for economic growth, inflation and current-account balances for 15 countries and for the euro area. The table also shows the highest and lowest projections for growth. The previous month's figures, where they are different, are shown in brackets. The panel has become gloomier about growth prospects in the euro area and Japan. It now expects the euro area to grow in 2005 by 1.7%, down from 1.9% a month ago. It thinks that Japan will grow next year by 1.9%, down from 2.1% in November. The panel has also scaled back its forecasts for growth in 2005 for several other countries, including Canada, Britain and Australia. However, it has raised its prediction for America, which it now expects to grow in 2005 by 3.5%, up from 3.4% last month.

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Money and interest rates

Dec 9th 2004
From The Economist print edition

	Money supply* % change on year ago			Interest rates % a year (Dec 8th 2004)					
				3-mth money market		2-year	10-year gov't bonds		corporate
	narrow	broad		latest	year ago	gov't bonds	latest	year ago	bonds
Australia	+ 5.0	+ 9.5	Oct	5.40	5.46	4.83	5.18	5.86	6.08
Britain	+ 5.8	+ 9.8	Oct	4.81	3.97	4.39	4.55	4.89	5.25
Canada	+15.6	+10.7	Oct	2.48	2.68	2.82	4.38	4.83	5.89
Denmark	+10.2	+ 9.5	Oct	2.25	2.35	2.41	3.80	4.48	5.14
Japan	+ 3.9	+ 2.1	Nov	0.02	0.02	0.11	1.41	1.30	1.50
Sweden	+ 1.4	+ 3.1	Oct	2.00	2.72	2.34	3.88	4.83	2.44
Switzerland	– 4.7	+ 0.4	Oct	0.76	0.27	1.00	2.19	2.64	2.26
United States	+ 4.6	+ 4.8	Oct	2.26	1.05	2.91	4.13	4.32	5.64
Euro area†	+ 9.0	+ 5.8	Oct	2.17	2.15	2.29	3.62	4.29	3.49

*Narrow: M1 except Britain and Sweden M0, broad: M2 or M3 except Britain M4. †Germany for bonds. Benchmarks: US 30-year 4.78%, Japan No. 265 1.43%. Central bank rates: US fed funds 2.00%, ECB refinancing 2.00%, BOJ overnight call 0.001%, BOE repo 4.75%. Sources: Commerzbank, Danske Bank, J.P. Morgan Chase, Royal Bank of Canada, Stockholmsbörsen, UBS, Global Insight, Westpac, Thomson Datastream. Rates cannot be construed as banks' offers.

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The Economist commodity price index

Dec 9th 2004
From The Economist print edition

1995=100

	Nov 30th	Dec 7th*	% change on one month	% change on one year
Dollar index				
All items	89.1	88.2	+ 1.8	– 1.3
Food	81.3	81.1	+ 2.3	– 9.6
Industrials				
All	99.8	97.9	+ 1.3	+ 9.9
Nfa†	82.1	81.4	+ 0.1	– 7.8
Metals	114.6	111.8	+ 2.1	+24.7
Sterling index				
All items	73.6	71.7	– 2.6	–11.5
Euro index				
All items	88.2	86.4	– 2.1	–10.3
Yen index				
All items	97.5	96.4	– 1.1	– 5.7
Gold				
$ per oz	448.98	452.25	+ 4.1	+11.0
West Texas Intermediate				
$ per barrel	49.06	41.40	–12.5	+30.3

* Provisional. † Non-food agriculturals.

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Stockmarkets

Dec 9th 2004
From The Economist print edition

Market indices

	Dec 8th	2004 high	2004 low	% change on one week	% change on record high	% change on Dec 31st 2003 in local currency	% change on Dec 31st 2003 in $ terms
Australia (All Ordinaries)	3,909.8	3,959.9	3,274.9	– 0.1	– 1.3	+18.3	+18.3
Austria (ATX)	2,364.0	2,364.0	1,568.9	+ 1.7	nil	+53.0	+60.9
Belgium (Bel 20)	2,906.4	2,911.2	2,244.2	+ 0.7	–21.1	+29.5	+36.2
Britain (FTSE 100)	4,703.9	4,805.3	4,287.0	– 0.7	–32.1	+ 5.1	+13.1
Canada (Toronto Composite)	9,003.7	9,064.5	8,123.5	– 0.7	–20.9	+ 9.5	+15.4
Denmark (KBX)	253.9	256.5	219.0	– 0.6	–15.9	+18.9	+25.3
France (SBF 250)	2,594.5	2,623.3	2,386.1	– 0.2	–40.9	+ 7.6	+13.2
(CAC 40)	3,775.0	3,844.1	3,465.3	– 0.6	–45.5	+ 6.1	+11.6
Germany (DAX)	4,201.4	4,216.4	3,647.0	+ 0.4	–47.9	+ 6.0	+11.5
Italy (BCI)	1,437.5	1,437.5	1,239.5	+ 1.8	–34.1	+14.4	+20.3
Japan (Nikkei 225)	10,941.4	12,163.9	10,365.4	+ 1.5	–71.9	+ 2.5	+ 4.9
(Topix)	1,099.7	1,217.9	1,022.6	+ 1.1	–61.9	+ 5.4	+ 7.9
Netherlands (AEX)	343.3	364.8	310.7	+ 0.2	–51.1	+ 1.7	+ 6.9
Spain (Madrid SE)	930.7	930.7	804.4	+ 0.6	–18.8	+15.2	+21.2
Sweden (Affarsvarlden Gen)	220.1	222.6	188.5	– 0.6	–45.0	+16.9	+24.0
Switzerland (Swiss Market)	5,566.7	5,934.4	5,309.7	+ 1.0	–33.8	+ 1.4	+ 8.4
United States (DJIA)	10,494.2	10,737.7	9,750.0	– 0.9	–10.5	+ 0.4	+ 0.4
(S&P 500)	1,182.8	1,191.4	1,063.2	– 0.7	–22.6	+ 6.4	+ 6.4
(NASDAQ Comp)	2,126.1	2,153.8	1,752.5	– 0.6	–57.9	+ 6.1	+ 6.1
Europe (FTSE Eurotop 300)*	1,033.4	1,038.6	940.9	– 0.1	–39.4	+ 7.9	+13.5
Euro area (FTSE Ebloc 100)*	888.0	891.2	787.2	+ 0.1	–42.7	+ 6.8	+12.3
World (MSCI)†	1,130.4	1,144.3	997.0	– 0.8	–22.0	+ 9.1	+ 9.1
World bond market (Citigroup)‡	661.5	661.5	575.1	+ 0.9	nil	+ 9.6	+ 9.6

*In euro terms. †Morgan Stanley Capital International index includes individual markets listed above plus eight others, in $ terms.
‡Citigroup World Government Bond Index, total return, in $ terms.

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Trade, exchange rates and budgets

Dec 9th 2004
From The Economist print edition

	Trade balance*, $bn latest 12 months	Current-account balance $bn latest 12 mths	Current-account balance The Economist poll % of GDP, forecast 2004	Current-account balance The Economist poll % of GDP, forecast 2005	Exchange rate trade-weighted† 1990=100 Dec 8th	Exchange rate trade-weighted† 1990=100 year ago	Currency units per $ Dec 8th	Currency units per $ year ago	Currency units per £	Currency units per euro	Currency units per ¥100	Budget balance % of GDP 2004‡
Australia	− 17.0 Sep	− 36.2 Q3	− 5.9	− 5.4	85.0	87.5	1.33	1.35	2.56	1.76	1.27	+ 0.7
Austria	− 0.1 Sep	− 1.1 Sep	− 0.5	− 0.6	103.3§	102.8	0.75	0.82	1.45	–	0.72	− 1.5
Belgium	+ 20.5 Sep	+ 13.0 Jun	+ 3.2	+ 3.2	103.6§	103.0	0.75	0.82	1.45	–	0.72	− 0.1
Britain	−103.2 Oct	− 41.7 Q2	− 2.5	− 2.7	103.9	100.3	0.52	0.57	–	0.69	0.50	− 3.2
Canada	+ 50.2 Sep	+ 26.7 Q3	+ 2.7	+ 2.3	92.9	88.2	1.23	1.31	2.36	1.63	1.17	+ 1.1
Denmark	+ 9.8 Sep	+ 6.6 Sep	+ 3.0	+ 2.6	107.2	106.4	5.60	6.08	10.8	7.43	5.35	+ 0.9
France	− 2.8 Sep	− 2.3 Sep	+ 0.2	+ 0.2	107.2§	106.4	0.75	0.82	1.45	–	0.72	− 3.7
Germany	+189.1 Oct	+ 91.5 Oct	+ 3.3	+ 3.1	105.0§	103.9	0.75	0.82	1.45	–	0.72	− 3.9
Italy	+ 2.4 Sep	− 12.6 Sep	− 0.9	− 1.0	76.4§	75.8	0.75	0.82	1.45	–	0.72	− 2.9
Japan	+135.8 Oct	+169.9 Oct	+ 3.5	+ 3.4	135.5	136.1	105	108	202	139	–	− 6.5
Netherlands	+ 35.0 Sep	+ 21.0 Q3	+ 2.9	+ 3.0	103.2§	102.4	0.75	0.82	1.45	–	0.72	− 2.9
Spain	− 68.5 Sep	− 38.5 Aug	− 3.3	− 3.6	77.6§	77.1	0.75	0.82	1.45	–	0.72	− 1.1
Sweden	+ 22.8 Oct	+ 26.2 Q3	+ 7.3	+ 6.6	83.6	83.1	6.78	7.32	13.1	9.00	6.48	+ 0.5
Switzerland	+ 7.9 Oct	+ 45.9 Q2	+11.7	+11.2	114.3	112.4	1.16	1.26	2.23	1.54	1.11	− 1.6
United States	−621.1 Sep	−571.9 Q2	− 5.5	− 5.6	90.4	96.3	–	–	1.93	1.33	0.96	− 4.4
Euro area	+100.1 Sep	+ 55.1 Sep	+ 0.5	+ 0.5	93.5	91.4	0.75	0.82	1.45	–	0.72	− 2.9
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*											
Finland	+ 14.6 Sep	+ 8.6 Sep	na	na	82.4§	81.7	0.75	0.82	1.45	–	0.72	+ 2.3
Greece	− 30.1 Sep	− 10.3 Sep	na	na	59.8§	59.5	0.75	0.82	1.45	–	0.72	− 5.3
Iceland	− 0.5 Oct	− 0.6 Q3	na	na	96.6**	93.2	62.4	73.3	120	82.8	59.6	+ 0.1
Ireland	+ 42.2 Sep	− 1.7 Q2	na	na	95.5§	94.7	0.75	0.82	1.45	–	0.72	+ 0.2
Luxembourg	− 4.3 Sep	+ 2.1 Q2	na	na	103.6§	103.0	0.75	0.82	1.45	–	0.72	− 0.4
New Zealand	− 2.6 Oct	− 3.9 Q2	na	na	107.3	102.5	1.42	1.54	2.73	1.88	1.36	+ 2.9
Norway	+ 32.5 Oct	+ 31.9 Sep	na	na	98.8	98.9	6.19	6.65	11.9	8.22	5.92	+ 8.2
Portugal	− 16.9 Aug	− 11.6 Sep	na	na	93.6**	93.3	0.75	0.82	1.45	–	0.72	− 2.9

*Merchandise. Australia, Britain, France, Canada, Japan and United States imports fob, exports fob. All others cif/fob. †Bank of England except §IMF, October average. ‡OECD forecast. **IMF, August average.

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Government budget balances

Dec 9th 2004
From The Economist print edition

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Overview

Dec 9th 2004
From The Economist print edition

Malaysia's economy showed signs of slowing. Industrial production rose by 6.9% in the year to October, down sharply from 10.0% in the year to September.

Taiwan's foreign-exchange reserves reached $239 billion at the end of November.

In the **Philippines**, consumer-price inflation accelerated to 7.6% in the year to November.

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Childhood

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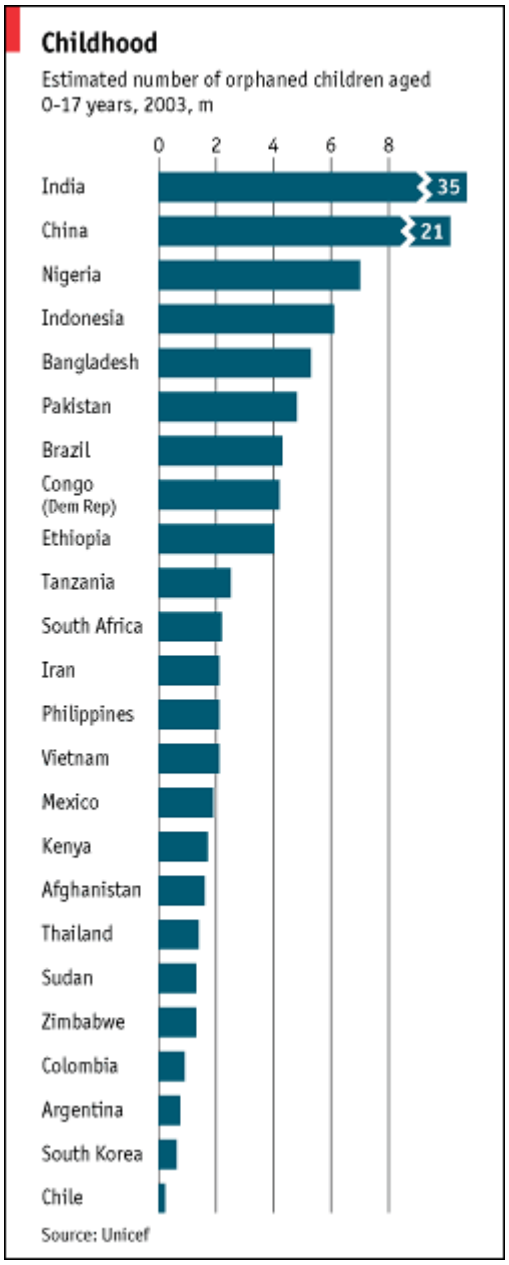
From The Economist print edition

Poverty, war and AIDS are making childhood a misery for more than one billion youngsters, according to *The State of the World's Children 2005*, published by Unicef. An estimated 15m children are orphans because of AIDS. Nearly half of the 3.6m people killed in conflicts since 1990 are children. Extreme poverty means that 640m children lack adequate shelter and 270m have no access to health care. Unicef urges governments to put more emphasis on children in designing development programmes.



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Economy

Dec 9th 2004
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	% change on year ago						Latest 12 months, $bn		Foreign reserves* $bn, latest
	GDP		Industrial production		Consumer prices		Trade balance	Current account	
China	+ 9.1	Q3	+14.8	Nov	+ 4.3	Oct	+26.6 Nov	+45.9 2003	514.5 Sep
Hong Kong	+ 7.2	Q3	+ 1.1	Q2	+ 0.2	Oct	−13.4 Oct	+13.6 Q2	121.5 Nov
India	+ 7.4	Q2	+ 7.7	Sep	+ 4.6	Oct	−20.3 Oct	+11.0 Q2	115.7 Oct
Indonesia	+ 5.0	Q3	− 2.3	Aug	+ 6.2	Nov	+25.6 Oct	+ 3.9 Q2	34.1 Oct
Malaysia	+ 6.8	Q3	+ 6.9	Oct	+ 2.1	Oct	+21.4 Oct	+13.6 Q2	58.6 Oct
Philippines	+ 6.3	Q3	+ 7.2	Sep	+ 7.6	Nov	− 1.2 Sep	+ 4.5 Jun	12.6 Nov
Singapore	+ 7.5	Q3	+ 2.4	Oct	+ 1.9	Oct	+15.6 Oct	+29.0 Q3	110.1 Nov
South Korea	+ 4.6	Q3	+ 5.7	Oct	+ 3.3	Nov	+29.4 Nov	+27.5 Oct	178.3 Oct
Taiwan	+ 5.3	Q3	+ 2.9	Oct	+ 1.5	Nov	+ 8.1 Nov	+24.8 Q3	239.1 Nov
Thailand	+ 6.0	Q3	+ 5.5	Oct	+ 3.0	Nov	+ 1.6 Oct	+ 7.2 Oct	45.1 Oct
Argentina	+ 7.0	Q2	+ 5.2	Oct	+ 5.6	Oct	+12.5 Oct	+ 4.6 Q2	18.6 Oct
Brazil	+ 6.1	Q3 2004	+ 7.6	Sep	+ 7.2	Nov	+33.0 Nov	+10.8 Oct	49.4 Oct
Chile	+ 6.8	Q3	+ 5.2	Oct	+ 2.5	Nov	+ 8.2 Nov	+ 2.0 Q3	15.7 Oct
Colombia	+ 2.4	Q3	+ 2.4	Sep	+ 5.8	Nov	+ 0.4 Aug	− 1.6 Q2	12.1 Oct
Mexico	+ 4.4	Q3	+ 5.5	Sep	+ 5.4	Oct	− 5.9 Oct	− 5.5 Q3	62.2 Sep
Peru	+ 4.5	Sep	+ 4.0	Sep	+ 4.0	Oct	+ 2.4 Oct	− 0.3 Q3	11.4 Oct
Venezuela	+15.8	Q3	+19.7	Aug	+19.5	Nov	+21.5 Q3	+14.4 Q3	16.1 Aug
Egypt	+ 4.3	2004†	+ 2.3	2003†	+11.9	Sep‡	− 7.5 Q2	+ 3.7 Q2	13.2 Jul
Israel	+ 3.4	Q3	+ 2.5	Sep	+ 0.8	Oct	− 6.5 Oct	+ 0.1 Q2	26.1 Oct
South Africa	+ 3.8	Q3	+ 6.1	Sep	+ 2.4	Oct	− 2.1 Oct	− 3.5 Q2	11.3 Oct
Turkey	+13.4	Q2	+ 1.5	Oct	+ 9.8	Nov	−32.5 Oct	−14.2 Oct	35.9 Oct
Czech Republic	+ 4.1	Q2	+ 6.6	Sep	+ 2.9	Nov	− 1.8 Oct	− 6.4 Q3	28.2 Nov
Hungary	+ 3.7	Q3	+ 6.7	Sep	+ 6.3	Oct	− 3.0 Q2	− 8.4 Q2	14.5 Oct
Poland	+ 6.1	Q2	+ 3.3	Oct	+ 4.5	Oct	− 5.1 Sep	− 3.4 Sep	34.1 Oct
Russia	+ 7.4	Q2	+ 3.5	Oct	+11.7	Nov	+78.6 Sep	+44.6 Q3	103.6 Oct
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*								
Estonia	+ 5.9	Q2	+ 6.3	Oct	+ 4.5	Oct	− 2.5 Sep	− 1.5 Q2	1.5 Sep
Latvia	+ 7.7	Q2	+ 3.3	Sep	+ 7.2	Nov	− 1.5 Sep	− 1.5 Sep	1.7 Sep
Lithuania	+ 6.0	Q3	na		+ 3.0	Nov	− 3.1 Sep	− 1.8 Q2	3.3 Sep
Slovakia	+ 5.3	Q3	+ 0.2	Oct	+ 6.3	Nov	− 1.1 Sep	− 1.0 Aug	12.8 Sep
Slovenia	+ 4.6	Q2	+ 3.9	Sep	+ 3.6	Nov	− 1.0 Sep	− 0.8 Sep	7.8 Aug
Pakistan	+ 6.4	2004†	+27.0	Jun	+ 8.7	Oct	− 4.3 Oct	+ 0.8 Q3	10.8 Sep
Saudi Arabia	+ 7.2	2003	na		nil	Sep	+59.1 2003	+28.0 2003	22.3 Sep

*Excluding gold, except Singapore; IMF definition. †Year ending June.

Sources: National statistics offices, central banks and stock exchanges; Thomson Datastream; Economist Intelligence Unit; Reuters; J.P. Morgan Chase; Hong Kong Monetary Authority; Centre for Monitoring Indian Economy; FIEL; EFG-Hermes; Bank Leumi Le-Israel; Standard Bank Group; Akbank; Deutsche Bank

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Financial markets

Dec 9th 2004
From The Economist print edition

	Currency units			Interest rates	Stockmarkets	% change on		
	per $		per £	short-term	Dec 8th		Dec 31st 2003	
	Dec 8th	year ago	Dec 8th	% a year		one week	in local currency	in $ terms
China	8.28	8.28	16.0	3.00	1,392.5	– 0.6	– 11.3	– 11.3
Hong Kong	7.77	7.76	15.0	0.50	14,022.3	– 1.0	+ 11.5	+ 11.4
India	43.9	45.5	84.6	5.27	6,261.5	+ 0.5	+ 7.2	+ 11.4
Indonesia	9,180	8,494	17,692	7.50	979.2	– 0.7	+ 41.5	+ 29.8
Malaysia	3.80	3.80	7.32	2.83	902.3	– 1.3	+ 13.6	+ 13.6
Philippines	56.1	55.4	108.0	7.00	1,801.2	– 0.8	+ 24.9	+ 23.7
Singapore	1.65	1.71	3.18	1.38	2,020.7	– 0.9	+ 14.5	+ 17.9
South Korea	1,059	1,186	2,040	3.37	871.7	– 0.6	+ 7.5	+ 21.0
Taiwan	32.1	34.0	61.9	1.25	5,892.5	+ 1.6	nil	+ 5.7
Thailand	39.5	39.8	76.1	2.15	645.4	– 1.5	– 16.4	– 16.1
Argentina	2.98	2.94	5.74	5.25	1,204.6	– 1.3	+ 12.4	+ 10.7
Brazil	2.76	2.93	5.32	17.24	24,968.0	– 1.1	+ 12.3	+ 17.4
Chile	584	606	1,125	2.52	8,965.7	– 1.0	+ 22.2	+ 24.1
Colombia	2,458	2,814	4,736	7.76	4,077.5	– 5.2	+ 74.7	+ 97.6
Mexico	11.3	11.2	21.7	8.34	12,113.6	– 1.0	+ 37.7	+ 37.2
Peru	3.32	3.48	6.39	3.01	3,543.5	– 1.9	+ 45.5	+ 51.9
Venezuela	2,569§	2,755§	4,952	12.37	29,479.6	– 0.5	+ 32.8	+ 47.4
Egypt	6.23	6.17	12.01	10.11	22,878.9	+ 0.3	+ 96.6	+ 94.5
Israel	4.34	4.40	8.36	1.00	614.8	+ 4.0	+ 15.0	+ 16.5
South Africa	5.87	6.45	11.3	7.55	12,205.2	– 3.0	+ 17.5	+ 33.7
Turkey	1,418,500	1,438,500	2,733,733	23.10	22,625.4	+ 0.3	+ 21.5	+ 20.3
Czech Republic	23.2	26.2	44.8	2.58	1,012.6	– 0.5	+ 53.6	+ 69.7
Hungary	185	216	357	9.57	14,430.0	+ 0.8	+ 53.8	+ 72.4
Poland	3.16	3.80	6.08	6.73	25,917.1	+ 1.2	+ 24.5	+ 47.6
Russia	28.0	29.5	54.0	13.00	574.1‡	– 6.1	– 3.1	+ 1.2
EMF (MSCI)*	1.00	1.00	1.93	na	511.1	– 1.4	+ 15.4	+ 15.4
EMBI+†	1.00	1.00	1.93	na	326.0	+ 1.2	+ 10.6	+ 10.6

*Emerging Mkts Free. †J.P. Morgan Chase's Emerging Mkts Bond Index Plus. ‡In $ terms. §Floating exchange rate.

Sources: National statistics offices, central banks and stock exchanges; Thomson Datastream; Economist Intelligence Unit; Reuters; J.P. Morgan Chase; Hong Kong Monetary Authority; Centre for Monitoring Indian Economy; FIEL; EFG-Hermes; Bank Leumi Le-Israel; Standard Bank Group; Akbank; Deutsche Bank

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